BUSINESS LAW SECTION

THE STATE BAR OF CALIFORNIA

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November 26, 2007

VIA E-MAIL: regulations@corp.ca.gov

Ms. Karen Fong
Office of Legislation and Policy
Department of Corporations
1515 K Street, Suite 200
Sacramento, California 95814-4052

Re: California Department of Corporations File No. PRO 41/06 —
Proposed Amendments to Section 260.204.9 of the California Code of Regulations

Dear Ms. Fong:

We are writing to comment on the above-referenced proposal (the "Proposal") issued by the California Commissioner of Corporations (the "Commissioner") to amend Section 260.204.9 of the California Code of Regulations. By letter dated November 8, 2007, we have commented separately on the proposed omnibus rulemaking relating to investment advisers (PRO 27/03).

These comments are provided on behalf of the Corporations Committee (the "Committee") of the Business Law Section of the State Bar of California (the "Business Law Section"), with authorization from its Executive Committee. The Committee is composed of attorneys with extensive experience advising California corporations and out-of-state corporations transacting business in California on, among other things, the California Securities Law and the rules of the Commissioner adopted thereunder.[1]

[1] Some members of the Committee practice in private law firms that regularly represent investment advisers doing business in California. Those Committee members were among the members principally responsible for preparing this letter. In addition to availing themselves of the information and resources of their private law firms, the Committee consulted with experienced members of the investment management bar, who are also members of the Business Law Section but not members of the Committee.

Summary

The Proposal would substantially restrict the exemption from registration for any investment adviser that has at least $25,000,000 of assets under management, that has fewer than 15 clients, and that does not hold itself out to the public as an investment adviser (the "Private Adviser Exemption").

The class of people affected by the change include those persons who manage what are generically called "hedge funds," and who have over $25 million in assets under management ("Hedge Fund Managers").[2] These privately-offered pooled investment vehicles are typically organized as limited partnerships or (generally to accommodate the needs of tax-exempt investors such as university endowments, foundations and pension funds, as well as non-U.S. investors) as non-U.S. corporations. Because each fund, if managed as a unit and without regard to the investment goals of its individual members, is considered under federal and California law to be one "client" of the manager, it is possible for the manager to use a limited number of partnership entities to amass significant assets under management, while having just a few "clients." The structure permits the manager to qualify for the 15-client exemption from registration under the federal Investment Advisers Act of 1940 (the "Advisers Act"),[3] and from California registration under the Private Adviser Exemption.

Under the Proposal,[4] federally-exempt Hedge Fund Managers with fewer than 15 clients and with a place of business in California may be required to register[5] with the California Department of Corporations (the "Department").[6]

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[2] Generally, Hedge Fund Managers with less than $25 million under management would be unable to register with the SEC and would not be exempt from registration in California.

[3] 18 U.S.C. §§ 80b-1 to 80b-21.

[4] The Proposal provides that an investment adviser with a place of business in California would be exempt from registration only if it (a) does not hold itself out to the public as an investment adviser; (b) is exempt from investment adviser registration with the Securities and Exchange Commission (the "SEC") under section 203(b)(3) of the Investment Advisers Act of 1940 (the "Advisers Act"); and (c) provides investment advice only to venture capital companies.

[5] We note that such advisers, even though exempt from the federal registration requirement, could elect to register with the SEC voluntarily. This would have the effect of preempting California's regulatory jurisdiction.

[6] The Committee takes no position as to whether the Hedge Fund Managers currently thought to be exempt from registration under the Private Adviser Exemption actually are "investment advisers" in the first place, as that term is defined in Corporations Code §25009, and this letter should not be interpreted to support any assertion that they are. We note that the Department had a longstanding policy letter, Policy Letter No. 151 (April 2, 1971), that reasoned that a general partner of a single investment partnership was not "advising others" within the meaning of the definition in §25009. Although Policy Letter No. 151 was withdrawn in 1998, some on the Committee felt that there remained questions about what the Legislature meant when defining "investment adviser." Further, the Committee notes that Section 25204 of the Corporate Securities Law authorizes the Commissioner to exempt "investment advisers" from Section 25230's registration requirement, but the Corporate Securities Law does not authorize the Commissioner to define what the term "investment adviser" means.

A. The Committee believes that the Commissioner should not adopt the Proposal at this time, for the following reasons.

1. Based on the Commissioner's Initial Statement of Reasons in support of the Proposal, we do not believe a need for this regulatory action has been demonstrated. The Initial Statement of Reasons appears to be based solely on controversial assertions made by the Securities and Exchange Commission ("SEC") in 2004 when it adopted a rule requiring Hedge Fund Managers with more than $25 million under management to register with the SEC. That rule was invalidated by a federal court, and the SEC has abandoned the effort to require those Hedge Fund Managers to register. The Committee does not think that the case for extending the Department's regulatory authority to Hedge Fund Managers is self-evident, and there is reason to think that the Commissioner's asserted factual predicates may not exist.

2. The Proposal is premature in light of recently adopted and pending SEC regulatory changes that may obviate the need for, or affect the scope of, action by the Commissioner.

3. Adoption of the Proposal would provide a disincentive for larger Hedge Fund Managers, an important industry, to locate in California, and could cause some Hedge Fund Managers to close their California offices.

4. Adoption of the Proposal would burden the existing system and divert limited Department resources, without offsetting benefits to investors.

B. If the Commissioner does not accept our recommendation summarized in A above, we would then recommend that the period for the submission of written comments be extended by ninety days to February 26, 2008.

C. If the Commissioner does not accept our recommendation summarized in A above and also does not accept our recommendation summarized in B above, we would then recommend that the Proposal be made effective no earlier than January 1, 2009 or at least one year from the date of adoption (whichever is later). We believe the additional time is necessary and appropriate in light of the significance of the burden imposed by the Proposal.

Commentary

A. The Proposal should not be adopted as drafted.

1. Based on the Commissioner's Initial Statement of Reasons in support of the Proposal, we do not believe a need for this particular regulatory action has been

demonstrated. The Initial Statement of Reasons appears to be based solely on controversial assertions made by the SEC in 2004 when it adopted a rule requiring Hedge Fund Managers with more than $25 million under management to register with the SEC. That rule was invalidated by a federal court, and the SEC has abandoned the effort to require those Hedge Fund Managers to register. The Committee does not think that the case for extending the Department's regulatory authority to Hedge Fund Managers is self-evident, and there is reason to think that the Commissioner's asserted factual predicates may not exist.

a. Similar Proposal by the SEC was Invalidated. The Initial Statement of Reasons For The Amendments of the Rule Changes Under the Corporate Securities Law of 1968 (the "Initial Statement of Reasons")[7] in support of the Proposal is based almost exclusively on assertions made in support of the SEC's own Hedge Fund Manager registration rule proposed in 2004 (the "SEC Rule"), as articulated in the SEC Release announcing adoption of the SEC Rule (the "Adopting Release").[8] The SEC approved the SEC Rule with a deeply divided 3-2 vote. The 2 dissenters felt so strongly about the SEC Rule that they took the unusual step of writing a 26 page dissent, taking issue with almost all of the reasoning behind the SEC Rule and challenging the factual accuracy of some of the majority's statements in support of the Rule. We have attached a copy of the dissent because we believe its reasoning is persuasive and because subsequent developments suggest the dissent's views may be more representative of the SEC's current thinking.

The SEC Rule was invalidated in the *Goldstein* decision.[9] The SEC, under its new Chairman, decided not to appeal that decision, and has not attempted to re-propose the SEC Rule, or a similar rule based on facts that might support its proposal (such as changes in the nature of investment adviser client relationships arising out of the growth and evolution of hedge funds). Nor has the SEC attempted to overcome the Court's criticisms.[10] Instead, the SEC has adopted new "antifraud" rule applicable to advisers to pooled investment vehicles, including hedge funds[11] and has proposed a heightened "accredited investor" standard specifically for investors in hedge funds (discussed further below).[12] The antifraud rule applies to all Hedge

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[7] California Department of Corporations, Initial Statement of Reasons for the Amendments of Rule Changes Under the Corporate Securities Law of 1968, *available at* http://www.corp.ca.gov/pol/rm/4106c.pdf.

[8] Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004), *available at* http://www.sec.gov/rules/final/ia-2333.htm, *vacated by Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

[9] *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

[10] *See Goldstein* at 882-84.

[11] 17 CFR 275.206(4)-8; Securities and Exchange Commission, Prohibition of Fraud By Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles (Effective September 10, 2007), Rel. No IA-2628; File No. S7-25-06; *available at* http://www.sec.gov/rules/final/2007/ia-2628.pdf (hereinafter "Prohibition of Fraud").

[12] *Id.*

Fund Managers whether or not registered with the SEC, California or any other state. And the proposed "accredited natural person" standard would apply to all U.S. offerings of hedge funds, regardless of the regulatory status of their investment advisers.[13]

The Proposal is inconsistent with the February 2007 Principles and Guidelines Regarding Private Pools of Capital, which was prepared by the President's Working Group on Financial Markets (consisting of the Secretary of the Treasury and the Chairs of the Federal Reserve Board, SEC and Commodity Futures Trading Commission (the "CFTC"); the "President's Working Group") with input from the Federal Reserve Bank of New York and the Office of the Comptroller of the Currency (the "Principles and Guidelines").[14] Instead of calling for more regulation of the hedge fund industry, the President's Working Group remarked that "The current regulatory structure...is working well." In a speech explaining the Principles and Guidelines, Robert K. Steel of the Treasury Department stated:

> "The President's Working Group did not view this issue through an anti-regulatory lens. In fact, if the Group believed that our regulators needed more authority to address these issues, Treasury Secretary Paulson would have led the charge in asking for it. However, ... the issues and challenges presented are complex and, unfortunately, will not be solved with a one-time regulatory fix. After serious and open-minded debate, we came to the conclusion that the principles and guidelines released last week provide the best answer."[15]

The current federal policy is not to require registration of investment advisers with fewer than 15 clients,[16] even if they have more than $25 million in assets.[17] Nor are most other states

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[13] In this connection, we note the recent statement by a Treasury Department official: "The combination of market discipline and existing regulatory authorities are well positioned to protect investors. The SEC continues to provide strong leadership on this issue. They have proposed raising the accredited investor standard, and already possess broad anti-fraud and anti-manipulation authority to investigate any manager – whether registered or not. I should add that the SEC is proposing an additional anti-fraud provision under its existing authority with respect to defrauding current or prospective investors." Remarks of Assistant Secretary for Financial Markets Anthony Ryan On Hedge Funds, World Hedge Fund Forum (Mar. 6, 2007), *available at* http://www.treas.gov/press/releases/hp296.htm.

[14] Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital (Feb. 2007), *available at* http://www.treasury.gov/press/releases/reports/hp272_principles.pdf (hereinafter "Principles and Guidelines").

[15] Remarks of Under Secretary for Domestic Finance Robert K. Steel On Private Pools of Capital (Feb. 27, 2007), *available at* http://www.treas.gov/press/releases/hp280.htm.

[16] Advisers Act, § 202(b)(3).

[17] Paradoxically, one potential consequence of requiring this class of advisers to register in California would be to drive advisers into registering with the SEC in order to avoid state-by-state regulation. Under Section 203A of the Investment Adviser Act of 1940, an adviser with more than $25 million in assets and fewer than 15 clients may voluntarily choose to register with the SEC, thereby pre-empting substantially all state investment adviser regulatory authority.

attempting to regulate this class of advisers. For example, New York and Connecticut, the two states with the highest concentrations of Hedge Fund Managers in the U.S., exempt most of them from registration.[18] Many of the other states with large financial service industries also have exemptions that apply to Hedge Fund Managers, including Illinois, Ohio, Oregon, Florida, Georgia, Maryland, New Jersey and Massachusetts.

At this time, there does not seem to be any consensus in either the investment management industry or among state or federal regulators of investment managers that there exists current problems involving Hedge Fund Managers that a registration requirement will fix. Without a showing that such problems in fact do exist, one cannot determine whether extension of the investment adviser registration regime to this group of advisers makes sense or not.

b. Industry Growth Does Not Justify Increased Regulation. In its Initial Statement of Reasons, the Department states that "the number of hedge funds is rapidly growing and the growth could have broad consequences for the securities markets. Reports have estimated that hedge fund assets exceed $1 trillion, and that hedge funds represent approximately ten to twenty percent of equity trading volume in the United States." This statement has two distinct parts. The first — that the number of hedge funds is rapidly growing — is not necessarily supported by the second — that hedge fund assets have been reported to exceed $1 trillion — and may not be true. Anecdotal experience of some Committee members suggests that the cited growth in hedge fund assets, and apparent additional asset growth in the more than four years since the report was issued is attributable primarily to increasing "institutionalization" of the hedge fund industry and concentration of assets with a shrinking number of Hedge Fund Managers.

Further, even if the growth in assets actually did suggest a rapid growth in the number of hedge funds or Hedge Fund Operators, as the dissent in the SEC's Adopting Release points out, regulatory requirements over an industry should not necessarily increase simply because it has grown.[19] The appropriate response to the hedge fund industry's asset growth should be to understand and address the effects that the growth may have on the investor-protection interests that are the Commissioner's proper and important province.[20]

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[18] *See Order Governing Certain Federally Exempt Advisers*, Connecticut Department of Banking Order (Oct. 14, 1997) (granting an exemption from state registration to any investment adviser that relies on the exemption in Section 203(b)(3) of the Investment Advisers Act); *see also* N.Y. GEN. BUS. LAW § 359-eee(1)(a)(5) (excluding advisers with fewer than six clients from the definition of investment adviser); N.Y. GEN. BUS. LAW § 359-eee(1)(a)(7) (granting an exemption from state registration to any investment adviser that relies on the exemption in Section 203(b)(3) of the Investment Advisers Act and applying the provisions of Rule 203(b)(3)-1); N.Y. COMP. CODES R. & REGS. tit. 13, § 11.12 (counting certain legal organizations as single clients).

[19] *See* Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Registration Under the Advisers Act of Certain Hedge Fund Advisers, *available at* http://www.sec.gov/rules/final/ia-2333.htm.

[20] *See id.*

Indeed, there are ongoing public and industry efforts to address the issues that the growth of assets in private investment pools raise. The Managed Funds Association has developed an extensive set of "Sound Practices for Hedge Fund Managers," which includes recommendations on management and internal trading controls, responsibilities to investors, valuation policies and procedures, risk monitoring, regulatory controls, transactional practices and business continuity and disaster recovery.[21] It expects to release its 2007 update later this year. As mentioned above, in February 2007, the President's Working Group on Financial Markets released the Principles and Guidelines.[22] The President's Working Group designed the report to establish a framework to inform its approach to working with market participants and rule makers regarding private pools of capital. As a second step, the President's Working Group on Financial Markets created a Hedge Fund Working Group in September 2007. That Group is currently considering a set of hedge fund best practices based on the Principles and Guidelines. The Group's goal is to provide recommendations to the President's Working Group by the end of 2007. The Group includes the concerns both of influential investors and Hedge Fund Managers.[23] Russell Read, the Chief Investment Officer of CalPERS, chairs a committee of investors in hedge funds, which will include representatives from labor organizations, endowments, foundations, corporate and public pension funds and investment consultants. Eric Mindich, who controls a fairly large hedge fund management firm, Eton Park Capital Management, L.P., chairs a fund managers' committee.

c. Purported Increase in Fraud Cases May Not Justify the Proposal. The Initial Statement of Reasons also cites an assertion in the SEC's Adopting Release that there was, in 2004, a growing number of enforcement cases in fraud by Hedge Fund Managers. Concern over such fraud was one of the primary reasons that the SEC conducted a large-scale study of the hedge fund industry beginning in 2003. That study resulted in the SEC's 2003 report *Implications of the Growth of Hedge Funds* (the "SEC Report"), to which the Initial Statement of Reasons refers. The SEC Report concluded, however, that: "There is no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity".[24]

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[21] Managed Funds Association, MFA's 2005 Sound Practices for Hedge Fund Managers (Aug. 2, 2005), *available at* http://www.managedfunds.org/downloads/MFA%202005%20Sound%20Practices.pdf.

[22] *See* Principles and Guidelines, *supra* note 13.

[23] According to the Treasury Department, the investors group will develop detailed guidelines for best practices for hedge fund investors, including practices regarding information, due diligence, and investment appropriateness. Specifically, the Treasury Department expects the investors group to address risk assessment and management, conflicts-of-interest, valuation, performance reporting, operations and controls, leverage, reporting and administration, among other issues. The hedge fund managers group will define best practices for managers regarding information, valuation and risk management systems. Specifically, the Treasury Department expects the hedge fund managers group to address reporting, conflicts-of-interest, valuation, trading practices, risk management, codes of ethics, settlement, recordkeeping, regulatory filings, compliance and business continuity and disaster recovery, among other issues. Testimony of Treasury Under Secretary for Domestic Finance Robert K. Steel before the U.S. House of Representatives Committee on Financial Services (July 11, 2007), *available at* http://www.treas.gov/press/releases/hp486.htm.

[24] Staff Report to the U.S. Securities and Exchange Commission, Implications of the Growth of Hedge Funds at 73 (Sept. 2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf (hereinafter "SEC Staff Report").

And while the SEC majority referred to fraud prevention and detection as a reason for adopting the SEC Rule, the 2 dissenting commissioners, noting that finding in the SEC Report, opined that the majority overstated the significance of the fraud concern, estimating that the cases the majority cited comprised less than two percent of total SEC cases during the relevant period. In addition, the General Counsel for the CFTC testified in 2004 that:

> "there has been very little fraud in the hedge fund arena. In the last 5 years, less than 3% of all enforcement actions by the CFTC and the SEC (81 out of 3,035) have been against hedge funds and/or their advisers."[25]

The Commissioner has not referred to any current evidence that hedge fund fraud is increasing.

We suspect that a comprehensive review of hedge fund fraud cases would show that the dissenting SEC commissioners' observations about the types of advisers involved in fraud cases remain true — that a large proportion involve managers too small to register with the SEC (i.e. less than $25 million).[26] Hedge funds below that threshold are also more likely than larger funds to have individuals as investors (as opposed to institutions). We suspect that these were among the factors involved in the Commissioner's decision in 2002 to limit the existing exemption in Section 260.204.9 to advisers with at least $25 million under management, rather than adopting a more expansive Private Adviser Exemption that would apply without regard to asset size, as some states have done.

This reasoning supports the Commissioner's decision in 2002 to structure the exemption as it did. By eliminating the exemption as proposed, only larger managers will be affected (those exempt from SEC registration after the *Goldstein* decision). Thus, the Proposal would divert Department resources from the class of managers posing the greatest risk and focus instead on larger, more institutional Hedge Fund Managers that have less incentive and less ability (due to more extensive oversight from sophisticated investors) to engage in fraudulent activity.

Next, most fraud is brought to light by tips from affected investors – rarely is it detected on inspections. So registration may help little in this respect. Alan Greenspan, the former Chairman of the Federal Reserve, testified in connection with the SEC Rule, "My problem with the SEC's current initiative is that the initiative cannot accomplish what it seeks to accomplish.

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[25] *Regulation of the Hedge Fund Industry: Hearing Before Senate Banking, Housing, and Urban Affairs Comm.*, 108th Cong. (July 15, 2004) (statement of Patrick J. McCarty, General Counsel, CFTC), available at http://banking.senate.gov/_files/mccarty.pdf).

[26] *See* Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Registration Under the Advisers Act of Certain Hedge Fund Advisers, *available at* http://www.sec.gov/rules/final/ia-2333.htm; *see also* SEC Hedge Fund Roundtable, Panel 6: Enforcement/Fraud Concerns at 7 (May 14-15, 2003) (presentation of Patrick J. McCarty, General Counsel, CFTC), *available at* http://www.sec.gov/spotlight/hedgefunds/hedge-mccarty.pdf.

Fraud and market manipulation will be very difficult to detect from the information provided by registration...."[27]

The Initial Statement of Reasons also mentions that hedge funds may be engaged in potential fraud against other market participants - *e.g*, insider trading. The SEC already has authority to investigate any investment adviser (whether or not SEC-registered) it believes is engaged in insider trading and in fact recently has made detection and prosecution of insider trading by hedge funds a higher priority.[28] The SEC has created sophisticated market surveillance techniques to identify potential insider trading – it does not just randomly select particular trades in the course of its on-site inspections. The SEC then routinely sends requests for information to hedge fund management companies with respect to particular securities trades that these surveillance tools identify as occurring close in time to a particular material event. These investigations are extremely fact-intensive and may not lead to any allegations or other action against the advisory firm.[29] Thus, allocating Department resources in this regard will be a waste of already thin resources, because its efforts will duplicate the SEC's extensive efforts in this area and also because it is simply unrealistic to expect that spot-checking of particular transactions in the course of Department inspections will detect any actual insider trading.

As previously mentioned, the SEC recently responded to language in the *Goldstein* decision by adopting a rule clarifying that the Advisers Act antifraud provisions — which apply to all investment advisers, whether SEC registered or not — prohibit advisers to investment companies, hedge funds and other pooled investment vehicles from making false or misleading statements to investors in those pools or to otherwise defraud those investors.[30] The SEC would enforce the rule though administrative and civil actions.[31]

d. Purported Broader Market Participation Does Not Justify the Proposal. The Initial Statement of Reasons also cites the broadening of market participants (what is often referred to by regulators as "retailization"). But the SEC reports the Commissioner cites do not establish even that such broadening existed in 2003, much less that it

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[27] *Regulation of the Hedge Fund Industry: Hearing Before Senate Banking, Housing, and Urban Affairs Comm.*, 108th Cong. (July 20, 2004) (statement of Alan Greenspan , Chairman, Federal Reserve Board).

[28] *See* Testimony of Linda C. Thomsen Concerning Insider Trading before the Committee on the Judiciary, U.S. Senate (Dec. 5, 2006), *available at* http://www.sec.gov/news/testimony/2006/ts120506lct.pdf.

[29] *See e.g. id.* ("We may open an investigation based on suspicious trading and all of the circumstances may look troubling, but after a through look, we may discover no evidence of insider trading or not enough evidence to prove there has been a violation of the law.")'; *see also "More Heat on Hedge Funds, Regulators are Probing Trades by Managers with Inside Access,"* Business Week (Feb. 6, 2006) available at http://www.businessweek.com/magazine/content/06_06/b3970066.htm, ("The SEC, NASD, and Financial Services Authority in London have launched a flurry of probes. So far the inquiries have resulted in only a handful of insider-trading charges against hedge fund managers.")

[30] *See* Prohibition of Fraud, *supra* note 10.

[31] *See id.*

is a continuing trend. The SEC Report stated "To date, . . . the staff has not uncovered evidence of significant numbers of retail investors in hedge funds."[32] In more recent testimony to the U.S. Senate Committee on Banking, Housing and Urban Affairs in July 2006 ("July 2006 Testimony"), Chairman Cox stated "[w]hile some refer to an alleged growing trend toward the 'retailization' of hedge funds, the Commission's staff are not aware of significant numbers of truly retail investors investing directly in hedge funds."

If retailization were actually occurring, it is not at all clear that it would justify imposing a registration requirement on Hedge Fund Managers that manage more than $25 million. First, direct investment (and indirect investment through so called funds-of-funds in which one fund invests in numerous other funds) in hedge funds remains limited to "accredited investors".[33] Even with increases in net worth due to inflation and increases in residential real estate values, this is an effective screen, preventing the least sophisticated and most vulnerable investors from investing in hedge funds. Second, while the Initial Statement of Reasons refer to an SEC assertion that minimum investment requirements for hedge funds have declined over time, we believe that may not be the case among larger Hedge Fund Managers — those who would be affected by the Proposal. Many of those managers' funds rely on Section 3.c.7 of the Investment Company Act of 1940[34] for exclusion from coverage (and thus registration under that Act) by limiting investors to "qualified purchasers" — generally, individuals with investments (excluding homes, and net of investment-related indebtedness) of at least $5 million and entities with such investments of at least $25 million.[35] This suggests that if "retailization," is occurring at all, it may well be limited to smaller Hedge Fund Managers, who are already subject to registration in California. The Initial Statement of Reasons does not refer to any factual information or investigation on this front. Finally, we note that the SEC has proposed tightening the definition of "accredited investor" specifically for investors in hedge funds in two key ways: first, the current "net worth" standard would be limited to "investments", with the effect that the value of an investor's primary residence would be excluded from consideration; and second, the dollar threshold would be increased from $1.0 million to $2.5 million.[36] If adopted, these

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[32] SEC Staff Report, *supra* note 24, at 80.

[33] *See id.* at 67-68; *see also* Testimony of William H. Donaldson Concerning Investor Protection Implications of Hedge Funds before the Senate Committee on Banking, Housing and Urban Affairs (Apr. 10, 2003), *available at* http://www.sec.gov/news/testimony/041003tswhd.htm.

[34] 15 U.S.C. §§ 80a-1 to 80a-64.

[35] Hedge funds commonly use one of two exemptions from the Investment Company Act definition of "investment company." Section 3.c.1 exempts an issuer the securities of which are owned by not more than 100 persons and which is not making and does not propose to make a public offering of its securities. Section 3.c.7 exempts issuers the securities of which are owned exclusively by persons who are "qualified purchasers" and which is not making and does not propose to make a public offering of its securities. Ordinarily, it is advantageous to Hedge Fund Managers not to have the number of investors in their fund be limited, and therefore, Hedge Fund Managers who can do so would have an incentive to opt for the higher accreditation standards set by 3.c.7.

[36] Prohibition of Fraud, *supra* note 10.

changes will significantly narrow the pool of accredited investors, especially in California, where the value of investors' homes have historically counted toward the accredited investor threshold.

The primary vehicles through which non-accredited persons indirectly participate in hedge funds – such as public and private pensions – are professionally managed and also use professional outside consultants. The President's Working Group stated in its Principles and Guidelines that "concerns that less sophisticated investors are exposed indirectly to private pools through holdings of pension funds, fund-of-funds, or other similar pooled investment vehicles can best be addressed through sound practices on the part of the fiduciaries that manage such vehicles." These pension fund managers and their outside consultants routinely require Hedge Fund Managers to complete voluminous questionnaires about management, investment procedures, and operational and risk controls, and they also conduct periodic on-site due diligence of those managers. Also, such pension funds are highly diversified – they allocate a relatively small percentage of their overall assets to hedge funds as an asset class and generally invest in a variety of different hedge funds, minimizing the risk posed by any single fund. Chairman Cox noted in his July 2006 Testimony that corporate and public pensions that invest in hedge funds allocate on average only about 5% of their assets to such investments.

The Financial Institutions Regulatory Authority, as successor to the supervisory oversight function of the NASD, has also taken an active role in protecting any investor that is referred to a hedge fund by a broker.[37] In 2003, the NASD issued a Notice to Members entitled "NASD Reminds Members of Obligations When Selling Hedge Funds", which reminds brokers that they must, among other things: (1) provide balanced disclosure in promotional efforts; (2) perform a reasonable-basis suitability determination; (3) perform a customer-specific suitability determination; (4) supervise associated persons selling hedge funds and funds of funds; and (5) train associated persons regarding the features, risks, and suitability of hedge funds.[38] The NASD enforced those requirements in actions against brokers that marketed hedge fund interests to investors.[39]

2. The Proposal is premature in light of recent and pending SEC regulatory changes that may obviate the need for, or affect the scope of, action by the Commissioner.

We believe the Commissioner's goals will be best served by waiting to consider the Proposal until other governmental agencies that are actively considering similar issues have finalized and adopted their proposals. As previously discussed, the SEC has recently adopted

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[37] NASD, Notice to Members, NASD Reminds Members of Obligations When Selling Hedge Funds (Feb. 2003), *available at* http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p003358.pdf.

[38] NASD, News Release, NASD Reminds Members of Obligations When Selling Hedge Funds (Jan. 24, 2003), *available at* http://www.finra.org/PressRoom/NewsReleases/2003NewsReleases/P002954.

[39] *See, e.g.*, NASD, News Release, NASD Fines Altegris Investments for Hedge Fund Sales Violations (Apr. 22, 2003), *available at* http://www.finra.org/PressRoom/NewsReleases/2003NewsReleases/P002940; NASD, News Release, NASD Fines Citigroup Global Markets, Inc. $250,000 in Largest Hedge Fund Sales Sanction to Date (Oct. 25, 2004), *available at* http://www.finra.org/PressRoom/NewsReleases/2004NewsReleases/P011819.

new antifraud regulations in direct response to the *Goldstein* decision and has proposed to increase the standard for "accredited investors" in hedge funds. And the Hedge Fund Working Group portion of President's Working Group is developing a set of best practices for the hedge fund industry to enhance investor protection and systemic risk safeguards. [40] These recent and pending measures may address some or all of the rationale articulated in the Initial Statement of Reasons for adopting the Proposal and certainly the work of the other groups should inform the Commissioner's own action with respect to the Proposal. If the Commissioner acts before the other governmental agencies, there is a risk of acting without full knowledge of the regulatory landscape for Hedge Fund Managers (which is likely to change in the near future) and that may inadvertently create gaps, overlaps or inconsistencies in regulation. Given the importance of the Proposal and its potential to affect dramatically California's hedge fund industry and possibly the California economy, we believe it is prudent to defer action on the Proposal until other pending reforms have been finalized.

3. Adoption of the Proposal would provide disincentives for Hedge Fund Managers, an important industry, to locate in California.

Since the current exemption was adopted in 2002 a number of national Hedge Fund Managers have opened offices in California, employing a variety of types of personnel. Many of these managers' operations are national and often global in nature, with offices in a number of states and countries. Their operations are heavily scrutinized by institutional investors' due diligence teams. Committee members have received feedback from several of these managers that subjecting their investment decisionmaking personnel (some of the most highly qualified, sophisticated, and experienced investment personnel in the world) to Series 65 examination[41] requirements, and subjecting their multi-state, even multinational operations to the requirements applicable to California-registered investment advisers, would be sufficiently disruptive as to cause them to close their California operations.

4. Adoption of the Proposal would burden the existing system and divert limited Department resources, without offsetting benefits to investors.

The Proposal presumably would cause an influx of applications and subsequent Form ADV updates from newly-registered managers. Routine applications for investment adviser registrations have in the last several years taken up to 90 days to process. Taken with the

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[40] On February 22, 2007, the President's Working Group released the Principles and Guidelines. See footnote 13, *supra*. On September 27, 2007 the President's Working Group announced chairs, members and mission statements for two private sector committees which "will assess and foster a private sector dialogue on issues of significance" to the industry and market. The committees' first task will be to establish "best practices" based on the guidelines issued in February. *See* Treasury Department Press Release, *"PWG Announces Private Sector Groups to Address Market Issues for Private Pools of Capital,"* Sept. 25, 2007, available at http://www.treas.gov/press/releases/hp575.htm.

[41] See California Code of Regulations §260.236 ("Qualifications of Investment Advisers, Investment Adviser Representatives").

Commissioner's proposed compliance rules for investment advisers (PRO 27/03), the changed regime could significantly increase the workload of the Department, and perhaps result in decreased attention to the class of advisers that the Department now regulates. As a balance against whatever regulatory benefits might result from extending the Department's regulatory jurisdiction, we hope that the Commissioner is giving due consideration to the drain on resources that such an action would entail. A regulatory lock-up would not be a good thing for either the Department or the regulated community.

B. If the Commissioner does not accept our recommendation summarized in A above, we would then recommend that the period for the submission of written comments be extended by ninety days to February 26, 2008.

Given the complexity of the Proposal and the concurrent development of standards and practices on the federal level (and within the investment management industry generally), the comment period should be extended to allow the members of the bar and members of the investment community to better understand and assess the legal and practical issues raised by the Proposal.

C. If the Commissioner does not accept our recommendation summarized in A above and also does not accept our recommendation in B above, we would then recommend that the Proposal be made effective no earlier than January 1, 2009 or at least one year from the date of adoption (whichever is later). We believe the additional time is necessary and appropriate in light of the significance of the burden imposed by the Proposal.

The Proposal does not indicate on what date it is to become effective. Because the Proposal eliminates the exemption from registration, Hedge Fund Managers previously entitled to the exemption might immediately be required to register the minute the Proposal becomes effective.[42] Hedge Fund Managers that would be required to register may need significant time to make arrangements for their investment decision-makers to take time away from their investment management duties to complete the Series 65 examination, as well as time to develop, adopt and implement compliance systems that meet the California requirements (such as the proposed compliance rule). Many unregistered Hedge Fund Managers currently maintain compliance procedures that are sophisticated and well tailored to their businesses, the laws that affect their market activities, and the demands of their institutional investors. However, these compliance procedures do not necessarily comply with California's detailed recordkeeping and other requirements, that have been developed for investment advisory businesses which may be very different from theirs. To comply with the California requirements, managers will need to engage compliance experts to educate them about specific requirements, develop and adopt written procedures tailored to their businesses, and train their personnel to implement the new procedures. These steps will require significant investments of advisers' time and attention. We

[42] *See supra* note 7. At the very least, adoption of the Proposal will result in uncertainty as to coverage of Section 25230 once the existing exemptions of the Private Adviser Exemption are eliminated, and that should be avoided.

see no public interest in setting a timetable for implementing the Proposal that may result in managers taking shortcuts or adopting generic or boilerplate policies and procedures. In adopting the SEC Rule (before it was invalidated), the SEC gave investment advisers approximately fourteen months from the date it was adopted to become registered. Advisers that are not accustomed to operating under the full requirements of the new California requirements or the Advisers Act will need time to develop and implement appropriate compliance procedures.

Moreover, the SEC's expansion of formalized compliance rules under the Advisers Act and other rules affecting investment advisers (such as the rules relating to proxy voting policies and codes of ethics) has vastly increased the demand for compliance professionals in this industry. Because of the scope of the compliance policies and procedures now required of registered advisers, many advisers who previously found periodic consultations with outside attorneys or consultants sufficient to meet their need for compliance expertise are now either seeking to hire in-house compliance experts or making historically unprecedented demands on outside compliance professionals. As a result, the market for experienced compliance personnel has become much more competitive. Many law firms and compliance consulting firms are losing experienced personnel to in-house employment with investment advisers, and many advisers are having trouble finding capable compliance officers. The Proposal will only intensify the already stiff competition to retain compliance personnel in an increasingly concentrated market. The compliance period should take into account that the infrastructure has not developed in the industry to meet the demands.

Therefore, if the Commissioner determines to go forward with the Proposal, we recommend that that its effective date be extended to January 1, 2009, or, if later, at least one year after the Proposal is adopted.

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We applaud the Commissioner for the significant effort it has undertaken in preparing the Proposal and will make our members available for in person conversation regarding the foregoing comments to the extent helpful during the Commissioner's consideration of the Proposal.

Please note that positions set forth in this letter are only those of the Corporations Committee. They have not been adopted by the Business Law Section, or its overall membership, or by the State Bar's Board of Governors or its overall membership, and are not to be construed as the position of the State Bar of California. Membership on the Committee and in the Business Law Section is voluntary, and funding for their activities, including all legislative activities, is obtained entirely from voluntary sources.

Please do not hesitate to contact either of the undersigned if you have any questions or concerns about the matters raised in this letter.

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ATTACHMENT

Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Registration Under the Advisers Act of Certain Hedge Fund Advisers

Four months ago, the majority proposed to regulate hedge fund advisers over our dissent.[1] We were nevertheless hopeful that a careful review of commentary on the proposal would convince the majority, instead of taking further action on this proposal, to consider better alternatives. Our hope was fueled by the fact that many commenters offered excellent insights and recommendations to the Commission. We are disappointed that the majority, unmoved by the chorus of credible concerns from diverse voices,[2] has determined to adopt the hedge fund registration rules largely as proposed.[3] As discussed below, we continue to agree that we need more information on hedge funds, but we disagree with the majority's solution.

Our main concerns with this rulemaking can be broadly divided into the following categories:

- There are many viable alternatives to this rulemaking that should have been considered.

The needed information about hedge funds can be obtained from other sources, including other regulators and market participants, as well as through a notice and filing requirement. The Commission should have collected and analyzed the existing information and determined what new information would be useful *before* imposing mandatory registration. Further, the Commission has failed to demonstrate that this is the least burdensome and most effective way to accomplish its objective.

- The pretext for the rule does not withstand scrutiny.

Just last year, the staff found that fraud was not rampant in the hedge fund industry, and that retailization was not a concern. Nonetheless, the majority repeatedly asserts that these issues justify imposition of the rulemaking. The fallacy of the majority's approach is apparent when one notes that registration of hedge fund advisers would not have prevented the enforcement cases cited by the majority, and the rulemaking will have the perverse effect of promoting, rather than inhibiting, retailization.

- The Commission's limited resources will be diverted.

At the open meeting, Chairman Donaldson stated that a task force had been constituted to identify hedge fund risks and implied that the task force would develop a targeted examination model. However, the task force should have completed its work prior to the promulgation of this rulemaking, so that it could be specifically tailored to address actual, as opposed to hypothetical, concerns. Under this rulemaking, the Commission will have to allocate its limited resources to inspect more than 1,000 additional advisers. Our concerns about the misuse of resources were validated when, just two days after the open meeting, the staff stated that, if the Commission cannot undertake its new examination responsibilities, it has in its "back pocket" the ability to shift resources from oversight of small advisers.[4] This possible shift should have been raised during the open meeting and weighed by the Commission in deciding whether to adopt the rule.

Our concerns are addressed in detail below.

I. The information that the Commission needs can be obtained from other sources.

We share the majority's objective of getting better information about hedge funds and would support alternative measures such as pooling of information from Commission registrants and other government agencies and self-regulatory organizations that collect data on hedge funds, enhanced oversight of existing registrants, a census of all hedge funds, and requiring additional periodic and systematic information to be filed with us. Although the majority anticipates without specificity that "registration would provide the Congress, the Commission and other government agencies with important information," Form ADV is unlikely to provide the information that the Commission needs. Before taking an action of the magnitude of this final rule, the Commission should have determined the information that it needs and worked with its fellow regulators and affected parties to obtain this information. Instead, the process by which the rule was proposed and adopted discouraged a true exchange of ideas about the proposed approach and alternatives.[5]

A. Coordination with other regulators should have been a prerequisite to unilateral Commission action.

Before adopting this rulemaking, the Commission should have coordinated with other government entities to aggregate the information that is available. The majority correctly notes that such information is not gathered in one convenient place, but we could work with other regulators to improve our and other agencies' access to information.[6] The Commission also could explore ways of expanding the form that the Department of Treasury has proposed to require all unregistered advisers to file as part of its anti-money laundering program for investment advisers.[7]

The majority approved the rulemaking three weeks after Congressman Baker, Chairman of the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, asked the President's Working Group on Financial Markets ("PWG")[8] to work out a data sharing agreement *before* the Commission proceeded with its rule.[9] Because the regulation of hedge funds has broad market implications, any regulatory requirement would be more appropriately addressed as part of a collaborative effort among the members of the PWG, all of whom apparently have concerns with our proposal.[10] In 1999 after the near collapse of Long Term Capital Management, the PWG issued a report that concluded that "requiring hedge fund managers to register as investment advisers would not seem to be an appropriate method to monitor hedge fund activity."[11] We agree with Chairman Greenspan that nothing has changed since then to warrant a different conclusion.[12]

The majority justifies going forward in the face of such opposition by arguing that the Commission alone among the PWG members bears the "responsibility for the protection of investors and the oversight of our nation's securities markets,"[13] but other regulators may be better suited to address some of the majority's specific areas of concern.[14] The majority, for example, did not consult the Department of Labor, which has primary jurisdiction over private pension plan advisers, about this rulemaking even though one of its justifications for the rulemaking is pension fund investment in hedge funds. The CFTC, with which many hedge fund advisers or sponsors are already registered, expressed serious concerns about duplicative regulation by the SEC and recommended an exemption for CFTC registrants.[15] Similarly, although the majority addressed a number of concerns raised with respect to

offshore funds, they did not adequately address, through discussions with foreign regulators, commenters' concerns about potentially duplicative regulation.[16]

B. Before proceeding with registration, the Commission should have enhanced its oversight of existing registrants.

Rather than adding to its stable of registrants, the Commission could have obtained useful information by monitoring transactions through its existing registrants. The Commission, for example, could enhance its oversight of prime brokers to detect and deter fraud by their hedge fund clients and obtain more information about hedge fund advisers.[17] More generally, market surveillance is an effective, targeted way of finding fraud, and would allow us to leverage the knowledge and expertise of other self-regulatory organizations.[18]

C. Commenters showed a commendable willingness to help the Commission obtain the information we need through mining existing information resources or developing new ones.

The commenters, the vast majority of which opposed mandatory registration, suggested a number of alternatives for ensuring that the Commission has ample information about hedge funds. Among the suggestions was requiring investment advisers that are exempt under sections (3)(c)(1) or (3)(c)(7) of the Investment Company Act of 1940[19] or rely on the safe harbor in rule 203(b)(3)-1 under the Advisers Act[20] to file and annually update information statements with the Commission.[21] These information statements could include information such as the names of all unregistered funds advised, the names and qualifications of the key owners and employees of the adviser, assets under management, other types of accounts managed, a list of the prime brokers used by the adviser, and performance data. The majority's footnote addressing this approach dismisses this as a variant of another suggested approach – expanded Form D reporting.[22] The majority refused to consider either approach because both lack an examination component.[23] For the reasons stated below, we do not believe that the examination aspect of hedge fund regulation will deliver the benefits that the majority believes it will and we are concerned with the diversion of resources that examination will entail.

II. Mandatory registration does not address the concerns underlying the rulemaking.

The majority cites three main bases for its action: the growth of hedge fund assets, the growth in hedge fund fraud, and the broader exposure to hedge funds. None of these justifies the majority's action.

A. The Commission should not necessarily increase its regulatory requirements on an industry simply because it has grown.

The majority points to the growth of the hedge fund industry as a concern underlying the action being taken. Given the industry's size,[24] the Commission has a basis for wanting more information about it, but the Commission should not assume that a greater level of regulation is needed in a flourishing industry with a wealthy and sophisticated investor base.

In the Proposing Release, the majority argued that registration would "legitimiz[e] a growing and maturing industry that is currently perceived as operating in the shadows."[25]

The Adopting Release does not repeat this dramatic language, but the underlying belief that there is something improper about not registering voluntarily is evident.[26] The Commission should not encourage an adviser's registration status to be viewed as a proxy for the adviser's honesty. There are many legitimate reasons for a hedge fund adviser not to register.[27]

B. Registration would not have prevented the violations in the enforcement cases cited by the majority.

While we acknowledge that hedge fund fraud exists and should be taken seriously, it appears, based on our knowledge, that the majority overstates its relative significance. The 2003 Staff Hedge Fund Report did not find disproportionate involvement of hedge funds or their advisers in fraud.[28] We estimate that the cases cited by the majority during the past five years comprise less than two percent of total SEC cases in the same period. The CFTC similarly found that only three percent of all SEC and CFTC enforcement actions were against hedge funds or their advisers.[29]

Citing to forty-six cases in the Proposing Release and five additional cases in the Adopting Release, the majority is requiring advisers to the most sophisticated investors to register based on fraud cases, most of which were directed at the least sophisticated investors. These cases do not provide a justification for mandatory registration because, in most, the hedge fund advisers would have been too small to be registered under the new requirement,[30] were already registered,[31] or should have been registered.[32] Many were garden-variety fraudsters who could as easily have called their schemes something other than "hedge funds." The majority argues that registration with the Commission permits it to screen registrants and deny registration to anyone who has been convicted of a felony or otherwise has a disciplinary history that warrants disqualification. Many of those implicated in our cases would not even have sufficient assets to be eligible for registration.[33] Others, whose sole objective was to defraud investors, likely would not even attempt to register, but would nevertheless perpetrate their frauds.[34]

The majority also points to the involvement of hedge funds in the recent market timing scandals as evidence of a need for registration. The illegal conduct occurred when advisers to mutual funds contravened their fund prospectuses by allowing hedge funds and others to engage in market timing. While the Commission also should pursue any securities law violations by hedge funds (and is doing so), it should not necessarily impugn hedge fund advisers for the *legally permissible* actions they took to enhance the performance of the hedge funds. Finally, to the extent hedge fund advisers committed illegal actions, it is difficult to believe that this rulemaking would have stopped them. Despite the Commission's examination authority over mutual fund advisers, all of whom must be registered under the Advisers Act, routine examinations did not uncover the illegal conduct. In addition, of the approximately 70 hedge fund advisers involved in these cases, at least 20 were registered.

In the hedge fund context, routine examinations will not be an effective tool for the Commission. The Commission already can invoke its subpoena power to investigate potential fraudulent abuses in hedge funds.[35] Certainly a perfectly-timed routine examination could expose fraud, but with so many registrants and so few examiners, it is unrealistic to anticipate that this will happen very often. Moreover, because hedge fund advisers tend to employ more complex investment strategies than the typical registered

adviser, the Commission will have to incur substantial training costs in order to understand and oversee the newly registered hedge fund advisers.[36] Chairman Donaldson envisions being able "to apply our manpower and expertise in an effective, risk-based system designed not only for this responsibility but ultimately as an underpinning for all examinations and inspections conducted by the Commission."[37] However, the Commission has not yet demonstrated the effectiveness of this new approach.[38] More specifically, the move towards risk-based oversight will not be effective if we have not identified relevant risk factors.[39]

The majority contends that, even if examinations do not routinely *detect* fraud, the threat of an examination will *deter* fraudulent activity by hedge fund advisers.[40] Any deterrent effect, however, is muted by the fact that the Commission lacks the resources necessary to conduct frequent, comprehensive hedge fund adviser examinations, and our lack of resources is a matter of public record.[41] The Chairman has publicly announced that the Commission is rethinking its inspection model, which historically has focused on site visits and information requests.[42] The new approach will not be centered around routine inspections. Heavy sanctions for fraudulent behavior are a more effective and cheaper deterrent than the specter of an examination every several years.[43] In making these observations, we are not questioning the need for a Commission examination program. Rather, we are suggesting that the Commission should not assume a task that is now handled by the market, particularly since it is a task the Commission is not equipped to perform.

C. Retail investors' exposure to hedge funds is limited and they can be protected through more effective means than registration.

The majority speaks ominously of the "retailization" of hedge funds, *i.e.*, their increasing accessibility through pension funds and funds of funds to unsophisticated investors of moderate means. The 2003 Staff Hedge Fund Report, however, found no retailization.[44] Moreover, the Report's conclusion is consistent with the views expressed at the Commission's May 2003 Roundtable, at which 60 panelists, including representatives of federal, state and foreign government regulators, securities industry professionals, and academics testified.[45] Hedge fund advisers appear willing to take steps to preclude retailization.[46] Raising the accreditation standards for hedge fund investors, for example, would reduce the number of high net worth individual investors, which is estimated already at fewer than 200,000, to an even smaller universe of investors. Alternatively, we could require registration for funds that allow relatively small investments.

Concern about the exposure of retirees through their pension funds, a cornerstone of the majority's retailization argument, is unwarranted. Although pension fund investment in hedge funds has grown in recent years, just one percent of the more than $6.4 trillion invested in U.S. pension funds is currently invested in hedge funds.[47] Pension fund investments are only eight percent of total hedge fund investments.[48] For every pension fund dollar invested in hedge funds, approximately three pension fund dollars are invested in other private investment funds,[49] yet the rulemaking carefully seeks to avoid reaching them. More generally, pension funds, as part of a risk diversification strategy, invest in hedge funds and other investments in which retirees might not be able to invest directly. Some of these investment vehicles, such as off-shore investment vehicles, venture capital

funds, and real estate investment trusts, are not advised by advisers registered with the Commission.

Pension funds, along with the universities and charitable organizations that the majority cites as contributors to the trend towards retailization, are managed by fiduciaries, who typically are highly-skilled.[50] These fiduciaries are responsible for determining whether to invest in hedge funds, the types of hedge funds in which to invest, and how to weigh risk and transparency issues in making these determinations.[51] Neither the information available on Form ADV nor the possibility that a particular hedge fund adviser will be subject to an inspection would substantially reduce these fiduciaries' due diligence obligations.

The majority also worries about retail investors' exposure to hedge funds through funds of hedge funds. Advisers so far have set investment minimums between $25,000 and $1 million.[52] There are a number of ways aside from universal registration to address concerns about retail exposure to these funds. The Commission could require the funds of funds that are targeted to retail investors, and all of their component funds, to have registered advisers.[53] Alternatively, the Commission could prohibit these funds from being publicly offered or place heightened restrictions on investors.

III. The majority's approach will have detrimental effects on investors, advisers, and the markets.

A. The new rule will necessitate a dangerous diversion of resources.

In order to administer the new requirement, the Commission will have to divert resources from the protection of unsophisticated investors, including more than 90 million mutual fund investors, to an estimated 200,000 individual and institutional hedge fund investors. This seems unwise so soon after we made the case that we did not have enough staff to oversee the existing pool of registered advisers and funds. In fact, just two days after the majority adopted this rulemaking, the Director of the Division of Investment Management reportedly said that an option that the Commission has in its "back pocket" is raising the threshold registration level to $40 million.[54] If the majority was seriously contemplating raising the registration threshold in connection with the rulemaking, it should have sought specific comment on the implications of such a change.[55]

The majority argues that all investors, sophisticated and not, are entitled to protection under the Advisers Act. Indeed, all investors do enjoy the protection of the Act's antifraud provisions. But, as Congress recognized in 1996 in connection with the adoption of Investment Company Act section 3(c)(7), "[financially sophisticated] investors can evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights."[56] In contrast to mutual fund investors, hedge fund investors have not been conditioned to rely on Commission oversight.[57] They can perform due diligence (or hire someone else to do so for them), review audit reports or third-party internal control reports, and enlist help if they suspect fraud or malfeasance.[58] By adopting the registration requirement, the Commission has upset the private-public balance and taken on a task that it might not have adequate resources to perform.[59]

B. The Commission has failed to demonstrate that this is the least burdensome and most effective way to accomplish its objective.

In addition to being costly to the Commission, the new registration requirement will be costly to affected advisers, and these costs will be passed on to investors. The majority approaches the costs of its action with a remarkable casualness and tries to shift responsibility for the cost-benefit analysis to commenters.[60] The majority accepts anecdotal evidence from those in support of the rulemaking, but rejects as complaints equivalent statements by those opposed.[61] The majority treats cost estimates provided by commenters as overestimates.[62] The majority failed to aggregate the initial costs associated with registration and did not estimate ongoing costs of compliance.[63]

The majority points to the fact that advisers that are already registered, including hedge fund advisers, are able to bear the costs associated with registration.[64] Yet the majority also argues that its action will level the playing field between hedge fund advisers by imposing the costs on currently unregistered advisers that are borne now only by voluntary registrants. Costs of registration vary across firms.[65] Currently, if the benefits of registration, such as wider appeal to pension funds and other investors, do not outweigh the costs, then hedge fund advisers do not register.[66] Costs are likely to be particularly onerous for small advisers.[67] According to some, registration costs will be even more burdensome for small hedge fund advisers than they are for other small advisers.[68]

The majority's cost-benefit analysis does not provide a realistic assessment of the direct costs associated with registration.[69] Even the Investment Counsel Association of America ("ICAA"), which supports the majority's action, took issue with the majority's minimization of costs.[70] Advisers must file Form ADV, and are likely to seek the assistance of an attorney because it is a public disclosure form.[71] Once registered, advisers face numerous substantive requirements, including recordkeeping, custody, and compliance requirements, all of which impose costs.[72] The majority failed to offer any quantitative estimate for the costs associated with the requirement to have a chief compliance officer.[73] Hosting a Commission examination team can be very costly, particularly in terms of the opportunity cost of those who must comply with increasingly burdensome document requests and stand ready to answer questions.[74]

In addition to the direct costs of complying with Commission rules, there are likely to be indirect costs as hedge funds advisers are dissuaded from employing complex investment strategies that they cannot explain to Commission examiners. Questions about those strategies are likely since the majority believes there to be substantial conflicts related to "management strategies, fee structures, use of fund brokerage and other aspects of hedge fund management."[75] As one commenter explained, "there is no doubt that hedge fund managers would abandon a lawful strategy that the Commission takes exception with rather than face the controversy and the associated distractions generated by the Commission's position."[76] The effects might be felt by the market as a whole.[77] Advisers might even limit their businesses in order to avoid registering.[78]

The majority reasons that the "costs appear small relative to the scale of the industry."[79] Further, the majority argues, hedge fund advisers' fees provide them with "a substantial cash flow."[80] It is not the Commission's job to make value judgments regarding the propriety of hedge fund advisers' management fees, which investors have agreed to pay and which presumably reflect the risks of establishing a hedge fund and the high costs of attracting talented managers. Resources used to pay for compliance with new regulatory mandates cannot be used for other purposes, such as hiring new employees or purchasing

outside research. Thus, unless the Commission determines that the benefits of imposing the requirements justify the costs, the Commission should not impose the costs.

C. The rulemaking may encourage retailization.

The majority's proposal ironically may stimulate retailization. First, pension funds and other institutional investors, who indirectly invest in hedge funds on behalf of individuals, might invest more money in hedge funds as a result of the rulemaking. Because such investment vehicles tend to limit hedge fund investments to those with registered advisers, the mandatory registration would expand the potential universe and encourage even more investment in hedge funds, which the majority suggests puts retail investors at risk. Second, if all hedge fund advisers are registered, there is likely to be grassroots demand for access to hedge funds by retail investors.[81] Section 208(a) of the Advisers Act prohibits advisers from representing or implying that they are "sponsored, recommended, or approved, or that their abilities or qualifications have in any respect been passed upon" by the government.[82] Registered advisers, however, may advertise themselves as SEC-registered (and anecdotal evidence suggests that they do). Those who are not familiar with the Commission's role likely will not understand how little this means, particularly because the majority has argued that registration will "legitimize" hedge funds.

IV. The majority's approach makes arbitrary distinctions between funds.

A. The definition of "private funds" covered by the rule is unsuitable.

"Private funds" are defined in the new rule on the basis of three characteristics. A "private fund" is a company: (1) that would be subject to regulation under the Investment Company Act but for the exception, from the definition of "investment company," provided in either section 3(c)(1) or 3(c)(7) of the Investment Company Act; (2) that permits investors to redeem their interests in the fund within two years of purchasing them; and (3) the interests of which are offered based on the investment advisory skills, ability or expertise of the investment adviser.[83] This definition is arbitrary and not reflective of a relevant difference among different types of private investment companies.[84]

The redemption period is the only criterion that would distinguish most hedge funds from most other types of private funds.[85] Even this criterion will pull into the rule other types of private investment funds, which the majority does not deem at this time to be in need of regulation.[86] More generally, at a time when there is already a trend towards longer lock-ups, this criterion will encourage advisers to extend their redemption periods beyond two years in order to avoid registration.[87] Therefore, it will be more difficult for investors, once they have made the decision to invest in a hedge fund, to "vote" on the quality and integrity of the hedge fund manager by leaving the fund.[88] A definition that looked, for example, to portfolio content or frequency of trading rather than redemption period would likely be more precise.[89]

B. If the majority's rationale for regulation of hedge fund advisers is sound, then it applies equally to advisers to private equity and venture capital funds.

We asked in our dissent to the proposal whether there was a basis for excluding advisers to venture capital and private equity funds. Valuation issues, for example, arise in the private

equity and venture capital funds, just as they do in hedge funds.[90] The National Venture Capital Association ("NVCA") filed a comment letter that explained that, while there are meaningful bases upon which to distinguish venture capital funds from hedge funds, the grounds on which the majority distinguished them are not meaningful. Fearing that these same justifications could be used in the future to require venture capital advisers to register, the NVCA opposed the proposal.[91] The majority continues to maintain that advisers to venture capital and private equity funds should remain beyond the scope of this rulemaking because they have not been implicated in as many enforcement actions as advisers to hedge funds have been.[92] We share the NVCA's concern that the majority has not meaningfully differentiated between hedge funds and other private investment funds. Just as the majority's justifications do not support the registration of hedge funds, they do not compel registration of any other type of private investment fund.

V. In taking this action, the majority has departed from regulatory and statutory precedent.

In order to carve out hedge fund advisers as a subset of advisers to private investment companies for registration, the majority has redefined "client" solely for this particular subset of advisers and then only to determine their eligibility to rely on section 203(b)(3). That section exempts from registration any adviser who during the past year has had fewer than fifteen clients and who does not hold himself out to the public as an investment adviser and does not act as an adviser to investment companies or business development companies.[93] Traditionally, for purposes of section 203(b)(3), advisers counted the funds, not the investors in those funds, as clients. The safe harbor in rule 203(b)(3)-1, which deems "the legal organization ... that receives investment advice based on its investment objectives rather than the individual investment objectives of its [owners]," confirms the propriety of this approach.[94] The majority, however, has now (i) amended rule 203(b)(3)-1 to deprive advisers to "private funds" of the safe harbor for counting clients afforded by that rule and (ii) added new rule 203(b)(3)-2 to require advisers to count each owner of a "private fund" towards the threshold of 14 clients for purposes of determining the availability of the private adviser exemption of section 203(b)(3) of the Act.

The majority's action marks a departure from the Commission's established approach of determining who an adviser's client is, namely by looking at whether or not the adviser is tailoring the advice to the financial situation and objectives of the individual investors or is simply providing advice to an entity in which individuals share the profits.[95] The core of the advisory relationship is the provision of individualized advice tailored to the needs and financial situation of the client. Thus, in 1997, when the Commission created a safe harbor to enable investment advisers to group clients together, it included safeguards to ensure that the adviser continued to treat each investor, not the group, as a client.[96] As the Commission explained:

> A client of an investment adviser typically is provided with individualized advice that is based on the client's financial situation and investment objectives. In contrast, the investment adviser of an investment company need not consider the individual needs of the company's shareholders when making investment decisions, and thus has no obligation to ensure that each security purchased for the company's portfolio is an appropriate investment for each shareholder.[97]

An adviser to a hedge fund is not expected to tailor its advice to the needs of individual owners of the fund, who do not necessarily have identical financial situations or objectives.[98]

Not only does the majority's action awkwardly depart from the established approach for identifying an adviser's clients, but the majority rejected compelling challenges to the Commission's statutory authority for this action.[99] When Congress first adopted the Investment Advisers Act in 1940, it did not look through investment companies and treat the underlying shareholders as the client. Rather, the Advisers Act treated the company itself as the client.[100] In this vein, section 203(b) of the Act as originally enacted exempted from registration "any investment adviser whose only clients are investment companies and insurance companies."[101] In 1970, when Congress, acting on the Commission's recommendation, amended the Act to require advisers to investment companies to register, it determined that "the shareholders of investment companies should have the same protections now provided for clients of investment advisers who obtain investment advice on an individual basis."[102] Advisers to *privately placed* investment companies, however, were not affected by the change. These advisers could still rely on the exemption from registration in section 203(b)(3) for advisers who do not hold themselves out generally to the public as advisers and have fewer than 15 clients.

The Commission assumes that removing the exemption would simply effect Congress' unspoken intent that any adviser who manages a significantly large asset pool must register. The majority points for support to the legislative history of Investment Company Act section 3(c)(1), which exempts investment companies with fewer than 100 owners.[103] But the legislative history of that section suggests that Congress understood that there would be asset pools, some of them large, that were not reached by the statute.[104] Congress has *not* amended section 203(b)(3) to require hedge fund advisers to register despite being aware that many hedge fund advisers are advising large pools of money without being registered. In fact, just eight years ago, Congress, recognizing "the important role that these pools can play in facilitating capital formation for U.S. companies," made the formation of large private pools easier.[105] Congress added section 3(c)(7) to the Investment Company Act to permit the formation of unregistered pools of an unlimited number of highly sophisticated investors.[106] The Committee report faulted "regulatory restrictions on these private pools" for driving American investors offshore.[107] The fact that many advisers to such pools were not registered under the Advisers Act was certainly known to Congress and allowing them to continue in their unregistered state was entirely consistent with Congress' objective of minimizing regulatory restrictions on such pools of assets.

VI. Conclusion

When we dissented from this rulemaking at the proposal stage, we asked for comment on a wide range of issues. We were interested in exploring different ways of getting more information about hedge funds, including working with other regulators and enhancing Commission oversight of existing registrants. Commenters responded with legitimate concerns about the costs and unintended consequences and offered their cooperation and a number of more feasible alternatives for addressing the Commission's concerns.

As the commenters pointed out, mandatory registration is an inappropriate response to the concerns underlying this rulemaking. The growth of the industry might support our call for more information, but it is not a valid justification for regulation. Registration is not likely to

deter or lessen substantially the harm of fraudulent activities of the type cited by the majority. The majority has failed to demonstrate that retailization is a problem, let alone that mandatory, universal registration would be the appropriate solution. Not only is the majority's rulemaking a poor solution for the problems that the majority cites, but it gives rise to unintended consequences. Among these are the imposition of substantial direct and opportunity costs on hedge fund advisers and their investors, and increased retailization. Moreover, implementing the rulemaking diverts Commission resources from the protection of retail investors. The Commission, in carrying out its mission, should apply its limited resources towards their highest and best use.

The majority also has failed to draw legitimate distinctions between hedge funds and other types of private investment pools that would justify different regulatory schemes. Questions about the wisdom of the majority's approach are compounded by questions about the propriety of this approach in light of legislative and regulatory precedent.

We hoped that the Commission would accord serious consideration to objections to their proposal. Today's rulemaking, which is the wrong solution to an undefined problem, disappoints those hopes and leaves better solutions unexplored.

For all of the foregoing reasons, we respectfully dissent.

Cynthia A. Glassman, Commissioner

Paul S. Atkins, Commissioner

December 2, 2004

[1] Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266 (July 20, 2004) [69 FR 45172 (July 28, 2004)] ("Proposing Release").

[2] In addition to the many comments the Commission received, the diversity of voices is illustrated by the appearance of editorials opposing the rulemaking in the *New York Times*, *Wall Street Journal*, and *Washington Post*. *See Hands off Hedge Funds*, Wash. Post, B6, July 18, 2004; *Reforming Hedge Funds*, N.Y. Times, D12, June 27, 2004; *The SEC's Expanding Empire*, Wall St. J., A14, July 13, 2004.

[3] Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004) ("Adopting Release").

[4] *See* Robert Schmidt, *Hedge Fund Rule May Cause SEC to Drop Smaller Firms, Roye Says*, Bloomberg (Oct. 28, 2004).

[5] Such a major shift in the Commission's regulatory approach warranted a significantly longer comment and comment review period than we afforded it. The proposal appeared in the Federal Register on July 28, 2004, and comments were due by September 15, 2004. Concerned about the brevity of the comment period and its inopportune timing during the vacation month of August, ten commenters requested a reasonable extension, but no extension was granted.

Moreover, once the comment period closed, the staff did not prepare a formal summary analyzing the issues raised by the more than 160 comment letters, most of which opposed the rule. Such summaries are standard procedure for rulemakings of this significance, because the summaries help ensure that the comments are considered by the commissioners and staff. The abbreviated discussion of the comment letters in the adopting release is not a sufficient substitute for a comment summary that is prepared before drafting the release to assist the Commission in deciding whether to adopt a proposed rulemaking and, if so, whether to make any changes.

The majority seems to have concluded that it had already heard all perspectives at the Commission's roundtable on hedge funds in May of 2003 and through the subsequent staff study. *See* Securities and Exchange Commission, Hedge Fund Roundtable (May 14-15, 2003) (transcript and webcast available at: http://www.sec.gov/spotlight/hedgefunds.htm) ("Roundtable"); Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission (Sept. 2003) (available at: http://www.sec.gov/news/studies/hedgefunds0903.pdf) ("2003 Staff Hedge Fund Report"). However, the roundtable and staff study disproved the existence of the problems that some thought might be found in the hedge fund industry. Consequently, the public did not have sufficient notice that a rulemaking would be forthcoming, much less of the specifics of the proposed rulemaking.

[6] The Commodity Futures Trading Commission ("CFTC"), for example, has offered to enter into an information-sharing arrangement with the Commission and other relevant agencies. *See* Comment Letter of the CFTC (Oct. 22, 2004). The National Futures Association, which is a self-regulatory organization for the futures industry, likewise offered to share the information that it collects about hedge funds. *See* Comment Letter of the National Futures Association (Sept. 14, 2004).

[7] Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Investment Advisers, 68 FR 23646 (May 5, 2003). The proposed rule would apply to, among others, any adviser that has at least $30 million in assets under management and is exempt from registration under section 203(b)(3) of the Investment Advisers Act [15 U.S.C. 80b-3(b)(3)], unless it is otherwise required to have an anti-money laundering program and is subject to examination by a federal regulator. *See* section 103.50(a)(2) of the proposed rule. [31 CFR 103.50(a)(2)]. As proposed, the form is intended to identify unregistered advisers, but the Commission could work with the Department of Treasury to tailor the form to elicit the information that the Commission determines that it needs.

[8] The President's Working Group is made up the heads of the Treasury, the Federal Reserve Board, the CFTC, and the SEC.

[9] *See* Letter from Congressman Richard H. Baker to John Snow, Chairman of the President's Working Group on Financial Markets (Oct. 7, 2004). Oddly, the majority cites this letter, the existence of which we learned about the day before the Open Meeting for this rulemaking, in support of the proposition that "During and after the comment period, our staff has continued to have discussions with other regulators relating to hedge fund adviser regulation." Adopting Release at n. 55.

[10] *See, e.g.*, Alan Greenspan, Chairman, Federal Reserve Board, Testimony before the Senate Banking, Housing and Urban Affairs Committee (July 20, 2004) ("My problem with the SEC's current initiative is that the initiative cannot accomplish what it seeks to accomplish. Fraud and market manipulation will be very difficult to detect from the information provided by registration under the 1940 Act."); Comment Letter of the CFTC (Oct. 22, 2004) (requesting exemption for CFTC-registered advisers that "would be complemented by a formal information sharing agreement between the CFTC and SEC related to CFTC-registered CPOs and CTAs"); Judith Burns, *Split SEC Set to Vote on Tighter Hedge Fund Oversight*, Dow Jones News Service, Oct. 25, 2004 ("Federal Reserve Chairman Alan Greenspan and Treasury Secretary John Snow worry that more regulation won't prevent fraud and could reduce benefits that hedge funds bring to markets.").

[11] Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management – Report of the President's Working Group on Financial Markets, at B-16 (Apr. 1999) (available at: http://www.treas.gov/press/releases/reports/hedgfund.pdf) (the Council of Economic Advisers, the Federal Deposit Insurance Corporation, the National Economic Council, the Federal Reserve Bank of New York, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision also participated in the study and supported its conclusions and recommendations). The majority contends that the report did not focus on issues relevant to the Commission's administration of the Advisers Act, but rather on "the stability of financial markets and the exposure of banks and other financial institutions to the counterparty risks of dealing with highly leveraged entities." Adopting Release at n. 43. The Commission cannot protect the nation's securities markets without considering the effect of its rules on the stability of the financial markets.

[12] *See* Alan Greenspan, Chairman, Federal Reserve Board, Written Responses to Questions from Chairman Shelby in Connection with Testimony before the Senate Banking, Housing and Urban Affairs Committee, at 3 (July 20, 2004).

[13] Adopting Release at n. 43.

[14] As the Commission has explained elsewhere, the Commission's interest in a particular area does not preclude its working with other regulators. *See, e.g.*, SEC, 2002 Annual Report 1 (available at: http://www.sec.gov/pdf/annrep02/ar02fm.pdf) ("Though it is the primary overseer and regulator of the U.S. securities markets, the SEC works closely with many other institutions ... ."). The Adopting Release notes that the staff met with staff of various fellow regulators, but because these meetings were not documented in the comment file, it is difficult to discern what occurred at those meetings. *See* Adopting Release at n. 17.

[15] *See* Comment Letter of the CFTC (Oct. 22, 2004) ("in the interest of good government and in order to avoid duplicative regulation, the CFTC respectfully requests that the SEC provide a registration exemption for these CFTC registrants that do not hold themselves out to the general public as investment advisers."). Many other commenters also recommended an exemption for CFTC-registered entities. The majority dismisses requests to exempt CFTC-registered commodity pool operators by arguing that Congress already addressed this concern by adding section 203(b)(6) to the Advisers Act in 2000 [15 U.S.C. 80b-3(b)(6)], but that section covers only commodity trading advisers, not commodity pool operators. *See* Adopting Release at text accompanying n. 128. We share the majority's hope that the

staff will consult with the CFTC staff regarding examinations, but staff discussions at the implementation stage cannot substitute for discussions about the Commission's proposal prior to adoption. *See* Adopting Release at n. 130.

[16] Many commenters recommended that the Commission should not require the registration of certain advisers that are subject to oversight by foreign authorities. *See, e.g.,* Comment Letter of the European Commission (Sept. 15, 2004); Comment Letter of the Fédération Européenne des Fonds et Sociétés d'Investissement (Sept. 15, 2004); Comment Letter of the Financial Services Roundtable (Sept. 15, 2004); the International Bar Association (Sept. 14, 2004).

[17] *See, e.g.*, Alan Greenspan, Chairman, Federal Reserve Board, Written Responses to Questions from Chairman Shelby in Connection with Testimony before the Senate Banking, Housing and Urban Affairs Committee, (July 20, 2004) ("If there was a public policy reason to monitor hedge fund activity, the best method of doing so without raising liquidity concerns would be indirectly through oversight of those broker-dealers (so-called prime brokers) that clear, settle, and finance trades for hedge funds. Although the use of multiple prime brokers by the largest funds would complicate the monitoring of individual funds by this method, such monitoring could provide much useful information on the hedge funds sector as a whole.").

[18] *See, e.g.*, Alan Greenspan, Chairman, Federal Reserve Board, Written Responses to Questions from Chairman Shelby in Connection with Testimony before the Senate Banking, Housing and Urban Affairs Committee (July 20, 2004) ("Concerns about market manipulation, whether by hedge funds or others, can best be addressed by enhanced market surveillance.").

[19] 15 U.S.C. 80a-3(c)(1) and 15 U.S.C. 80a-3(c)(7).

[20] 17 CFR 275.203(b)(3)-1.

[21] A number of commenters suggested this approach or a similar annual census form for hedge fund advisers. *See, e.g.*, Comment Letter of the American Bar Association, Section of Business Law (Sept. 28, 2004); Comment Letter of Sheila C. Bair, Professor of Financial Regulatory Policy, University of Massachusetts –Amherst (Sept. 15, 2004); Comment Letter of the U.S. Chamber of Commerce (Sept. 15, 2004); Comment Letter of Kynikos Associates (Sept. 15, 2004); Comment Letter of the Managed Funds Association (Sept. 15, 2004); Comment Letter of Seward & Kissell LLP (Sept. 15, 2004); Comment Letter of Schulte Roth & Zabel, LLP (Sept. 15, 2004); Comment Letter of Tudor Investment Corp. (Sept. 15, 2004). Other commenters suggested requiring hedge fund advisers to file audited financial statements. *See, e.g.*, Comment Letter of Madison Capital Management LLC (Sept. 15, 2004); Comment Letter of James E. Mitchell (Sept. 1, 2004); Comment Letter of Joseph L. Vidich (Aug. 7, 2004); Comment Letter of Willkie, Farr & Gallagher (Sept. 13, 2004) (recommending self-executing exemptive application procedure for advisers that provide investors with audited financials and valuation disclosures).

[22] *See* Adopting Release at n. 150.

[23] *See* Adopting Release at text accompanying n. 154. The majority also concluded that it was not worthwhile for the staff to try to make use of the information generated by existing transactional reporting requirements. *See* Adopting Release at text following n. 155. This seems to be a premature conclusion, particularly in light of commenters' suggestion to tailor current forms so that they meet the Commission's information needs. *See, e.g.*, Comment Letter of Bryan Cave LLP (Aug. 16, 2004) (recommending extensive amendments to Regulation D and Form D and Suspicious Activity Reports); Comment Letter of Madison Capital Management LLC (Sept. 15, 2004); Comment Letter of Proskauer Rose LLP (Aug. 31, 2004); Comment Letter of Tudor Investment Corp. (Sept. 15, 2004).

[24] The majority estimates the hedge fund industry to be $870 billion, which is dwarfed by the approximately $23 trillion under management by registered advisers. *See* Adopting Release at text accompanying n. 19 and following n. 71.

[25] Proposing Release, *supra* n. 1, at text following n. 183.

[26] This belief manifests itself in the perfunctory manner in which the majority dismisses legitimate concerns from opposing commenters by challenging the commenters' integrity. *See, e.g.,* Adopting Release at text accompanying n. 87 (noting, that hedge fund advisers "should be particularly sensitive to the consequences of getting caught if their conduct is unlawful. ... This sensitivity, which may be reflected in the strength of the opposition among some hedge fund advisers to this rulemaking, suggests that the marginal benefits of our oversight may be substantial."). *See also* William H. Donaldson, Chairman, SEC, Testimony before the Senate Banking Committee (July 15, 2004) (video testimony available at: http://banking.senate.gov/index.cfm?Fuseaction= Hearings.Detail&HearingID=122) ("I don't get much push back from people that are operating good funds. I don't get much push back from people who have nothing to hide.").

[27] *See, e.g.,* Comment Letter of Amaranth Advisors LLC (Sept. 15, 2004) (hedge fund adviser explains that it does not operate in the shadows, but under the scrutiny of a number of regulators); Comment Letter of the Greenwich Roundtable (Sept. 15, 2004) ("The hedge fund industry is already a highly legitimate and professional industry. Sophisticated investors in the hedge fund community make significant allocation decisions based in large part on the rigorous due diligence examinations that they personally perform prior to making an investment."); Comment Letter of the Managed Funds Association (Sept. 15, 2004) (detailing regulatory obligations to which hedge fund advisers are subject). The perception that hedge funds operate in the shadows might be attributable partially to the limitations to which hedge fund advisers are subject. *See, e.g.*, Testimony of Michael Neus, Principal and Chief General Counsel, Andor Capital Management, LLC, at the Hedge Fund Roundtable, *supra* n. 5 (May 14, 2004) ("it's a highly professional, highly organized industry which, because of restrictions on advertising or holding yourself out to the public, we are not capable of sharing with the general public ...").

[28] *See* 2003 Staff Hedge Fund Report, *supra* n. 5, at 73. The majority notes that it is "not alone in [its] concerns regarding hedge fund frauds" and cites the results of interviews with managers of European financial institutions about the state of the European Financial Market. *See* Adopting Release at n. 27 (citing Bank of New York, Restoring Broken Trust: A Pan European Study of the Causes of Declining Trust in the European Financial Services Industry and Analysis of the Actions Needed to Rebuild Investor Trust (July 2004). While

interesting, the opinions expressed by these European managers are largely immaterial in the context of the U.S. industry, and it is not clear how today's rulemaking will address these concerns.

[29] *See* Testimony of Patrick J. McCarty, General Counsel of the CFTC, before the U.S. Senate Committee on Banking, Housing and Urban Affairs 1 (July 15, 2004). *See also* Comment Letter of the National Futures Association (Sept. 14, 2004) (NFA's experience with the hedge funds it oversees is "consistent with the comparatively small number of CFTC and SEC enforcement actions involving commodity pool and hedge fund activities.").

[30] Hedge fund advisers, like other advisers, generally will be *required* to register only if they have assets under management of $30 million or more and advisers with between $25 million and $30 million will be *permitted* to register. *See* Investment Advisers Act section 203A(a)(1) [15 U.S. 80b-3a(a)(1)] and rule 203A-1 [17 CFR 275.203A-1] thereunder.

[31] The majority states that "[o]ur examination staff uncovered, during routine or sweep exams, five of the eight cases we brought against registered hedge fund advisers ... ." Adopting Release at n. 94 and accompanying text. One of those cases was uncovered during a sweep examination that was prompted by a civil complaint filed by the New York Attorney General. *See* In the Matter of Alliance Capital Management, L.P., Investment Advisers Act Release No. 2205 (Dec. 18, 2003). In another, the problem was not discovered until seven years after it began. *See* In the Matter of Portfolio Advisory Services, LLC and Cedd L. Moses, Investment Advisers Act Release No. 2038 (June 20, 2002). The Commission cannot rely on registration to unearth violations in a prompt and predictable manner.

[32] In our dissent to the Proposing Release, we discussed these 46 cases in detail. *See* Proposing Release, *supra* n. 1, at 45197-98. The advisers implicated in the five newly-identified cases likely would fall outside the scope of the rulemaking. *See* SEC v. Haligiannis, et al, Litigation Release No. 18853 (Aug. 25, 2004) (having raised $27 million over eight years, the hedge fund's president and general partners likely would not have been required to register); SEC v. Scott B. Kaye, et al., Litigation Release No. 18845 (Aug. 24, 2004) (having raised only $1.9 million, the adviser likely would not have been required to register); SEC v. Gary M. Kornman, Litigation Release No. 18836 (Aug. 18, 2004) (individual that used inside information to make trades on behalf of hedge funds was owner of broker-dealer registered with the Commission); SEC v. Anthony P. Postiglione, Jr., et al., Litigation Release No. 18824 (Aug. 9, 2004) (having raised approximately $5 million, the adviser likely would not have been required to register); SEC v. Adam G. Kruger and Kruger, Miller, and Tummillo, Inc., Investment Advisers Act Release No. 2297 (Sept. 15, 2004) (having raised approximately $1 million, the adviser likely would not have been required to register).

[33] The majority anticipates that hedge fund investors will demand that even new hedge fund advisers register. These advisers will be able to register even before they have $25 million under management if they have a reasonable expectation of meeting the $25 million threshold within 120 days. *See* rule 203A-2(d) [17 CFR 275.203A-2(d)]. It is not realistic to assume that all new advisers would register. Reaching $25 million in assets under management within four months is likely to be an unrealistic goal for many.

[34] *See also* SEC v. Sanjay Saxena, Litigation Release No. 16641 (Aug. 2, 2000) (having already been barred by the Commission from acting as an investment adviser, the defendant used his wife as a front for his advisory activity).

[35] The Commission, for example, employed its subpoena power in order to impose a broad document request on unregistered hedge fund advisers to enable the staff to gather information for the 2003 Staff Hedge Fund Report. *See supra* n. 5.

[36] *See, e.g.,* Comment Letter of W. Hardy Callcott, Bingham McCutchen LLP (Sept. 15, 2004) (anticipating that addition of hedge fund advisers to examination pool could disproportionately slow the examination cycle for all advisers because "it is likely to take a substantial amount of time and effort for [] examiners to understand what they are seeing – hedge fund trading strategies and operations are often far more complex than those at mutual funds and retail-oriented investment advisers").

[37] Chairman William H. Donaldson, Remarks at Open Meeting: Registration of Hedge Fund Advisers (Oct. 26, 2004).

[38] *See* Comment Letter of W. Hardy Callcott, Bingham McCutchen LLP (Sept. 15, 2004) ("The Commission should not rely on a risk assessment model to replace regular cycle examinations – certainly not until such a model has been rigorously tested and has a track record of effective implementation.").

[39] As Chairman Greenspan noted:

Even should SEC's proposed risk evaluation surveillance of hedge funds detect possible trading irregularities, which I doubt frankly, those irregularities will likely be idiosyncratic and of mainly historic interest, because by the time of detection, hedge funds would have long since moved on to different strategies.

Alan Greenspan, Chairman, Federal Reserve Board, Testimony before the Senate Banking, Housing and Urban Affairs Committee (July 20, 2004).

[40] *See* Adopting Release at text accompanying nn. 87-88. Because examinations take place so infrequently, the marginal increase in the chance of getting caught will not change the fraudster's calculus significantly. Further, the majority, to be consistent in its deterrence analysis, should take into account the shift of resources away from other types of advisers and hence the resulting decrease in deterrence for those advisers, particularly because they see the Commission's focus on hedge fund advisers as an area of emerging risk.

[41] As Chairman Donaldson noted when testifying before Congress this year, the Commission has only 495 staff conducting examinations of approximately 8,000 mutual funds, managed in over 900 fund complexes, as well as more than 8,000 investment advisers. *See* Testimony of William H. Donaldson, Chairman, Securities and Exchange Commission, before the House Subcommittee on Commerce, Justice, State, and the Judiciary, Committee on Appropriations (Mar. 31, 2004) ("During most of the period from 1998 to early 2003, the SEC's examination program for funds and advisers had approximately 370 members on its staff (including examiners, supervisors, and support staff). Routine examinations were conducted every five years. In the last two years, program staffing was increased by one-

third, to approximately 495 employees. With this staffing increase, the SEC has increased the frequency of examinations of funds and advisers posing the greatest compliance risks, and is conducting more examinations targeted to areas of emerging compliance risk.").

[42] Testimony of William H. Donaldson, Chairman, SEC, before the Senate Committee on Banking, Housing and Urban Affairs (July 15, 2004) ("I have asked the staff to develop an enhanced risk-based approach to oversight and examination of our investment adviser registrants, including hedge fund advisers.").

[43] Periodic examinations would likely have no deterrent effect on scam artists, who, under the guise of operating a hedge fund set out to steal money from unwitting investors, because these types of individuals will simply not register.

[44] 2003 Staff Hedge Fund Report, *supra* n. 5, at 80 ("To date, however, the staff has not uncovered evidence of significant numbers of retail investors in hedge funds.").

[45] *See, e.g.*, Testimony of Robert Schulman, Chairman and CEO, Tremont Asset Management, at the Roundtable, *supra* n. 5 (May 14, 2004) ("It is not a massive flow of money from retail or high net worth investors using registered products. That's not what's fueled the growth here to date. It may come to be that, but that's not what it's been today.").

[46] *See, e.g.*, Comment Letter of the Managed Fund Association (Sept. 15, 2004) (noting the validity of the Commission's concern about the increased number of persons qualifying as individual investors and recommending an adjustment of the accredited investor standard); Comment Letter of Porter, Felleman, Inc. (Aug. 16, 2004); Comment Letter of Tudor Investment Corp. (Sept. 15, 2004). And if, as the majority notes, hedge fund inflows already are so rapid that hedge fund advisers have more to invest than they can handle, then they will not need to look to retail investors. *See* Adopting Release at n. 21 and accompanying text.

[47] *See* Greenwich Associates, Press Release, *Alternative Investments May Disappoint Dabblers* (Jan. 21, 2004) (available at: http://www.greenwich.com).

[48] This assumes that $72 billion of pension money is invested in hedge funds, which are estimated to have total assets of $870 billion. *See* Adopting Release at n. 38 and text accompanying n. 19. The majority does not tell us what proportion of pension fund investments are invested in hedge funds without registered advisers.

[49] *See* Hewitt Investment Group, *In Brief: Immunization – Theory and Practice* 5 (July 2004) (available at: http://www.hewittinvest.com/pdf/InBrief_Immunization.pdf) (citing *Greenwich Associates Market Characteristics 2003 Report*) (based on asset allocation of private pension funds). *See also* Comment Letter of the National Venture Capital Association (Sept. 15, 2004) (noting that pension funds, foundations and university endowments have long invested in venture capital funds).

[50] The Department of Labor oversees the conduct of private pension plan advisers. In the public pension fund context, state law requires that the pension fund adviser, often an elected official, act for the benefit of the pensioners.

[51] *See, e.g.*, Transcript of Chronicle of Higher Education Colloquy with John S. Griswold of the Commonfund Group, (May 27, 2004) (available at: http://chronicle.com/colloquylive/2004/05/endowments/) (noting the role alternative investments, including hedge funds, play in diversifying endowment portfolios, reducing portfolio risk, and boosting returns).

[52] *See* 2003 Hedge Fund Report, *supra* n. 5, at 69.

[53] *See, e.g.*, Comment Letter of Leon M. Metzger (Sept. 15, 2004).

[54] *See supra* n. 1. Another option discussed in the Adopting Release is asking Congress for more funding, a request Congress might be loathe to fulfill absent assurances the new funds would not again be applied to expand our regulatory reach. *See* Adopting Release at Section V.

[55] Although both the Proposing and Adopting Releases mentioned raising the threshold for registration "to a slightly higher amount" as a possible way of compensating for the increase in registered advisers resulting from the rulemaking, the Proposing Release did not solicit comment on whether this was an appropriate reallocation of resources. *See* Proposing Release, *supra* n. 1, at section V and Adopting Release at section V.

[56] S.R. 104-293, at 10 (June 26, 1996).

[57] *See, e.g.*, Comment Letter of the Greenwich Roundtable (Sept. 15, 2004) (nonprofit organization made up of private and institutional investors opposed the rulemaking), Comment Letter of Rodney C. Pitts (Sept. 15, 2004) (hedge fund investor suggesting that Commission resources should not be diverted to protect the relatively small number of hedge fund investors), Comment Letter of Myra Tatum, Pointer Management Co. (Aug. 26, 2004) (manager of fund of funds noting that mandatory registration will not benefit investors; fund of funds manager already conducts extensive due diligence and ongoing monitoring of hedge fund managers). The majority cites a survey conducted by the Hennessee Group in support of its rulemaking. *See* Hennessee Group, 2004 Hennessee Hedge Fund Survey of Foundations and Endowments (submitted as a comment letter for this rulemaking). While 59 percent of the 46 respondents supported the rulemaking, foundations and endowments opposing the rulemaking were larger, more heavily invested in hedge funds, and had more years of experience in hedge fund investment than entities that favored the rulemaking. *See id.*

[58] As one commenter pointed out, "the 'institutionalization' of the hedge fund market has had many salutary effects on the industry [because] [m]ost such institutions require funds to complete voluminous questionnaires about management, investment procedures, and operational and risk controls." Comment Letter of Schulte, Roth & Zabel LLP (Sept. 15, 2004). Moreover, reports by auditors are a commonly-used method of demonstrating the integrity of internal controls. *See, e.g.*, Codification of Accounting Standards and Procedures, Statement on Auditing Standards No. 70, *Service Organizations*. *See also* Comment Letter of Blanco Partners LP (Sept. 13, 2004) ("We feel that having the highest quality attorneys, auditors and prime[] brokers is a selling point for our fund."). In other contexts, the Commission views favorably the use of outside control reports. *See, e.g.*, Fair Administration and Governance of Self-Regulatory Organizations; Disclosure and Regulatory

Reporting by Self-Regulatory Organizations; Recordkeeping Requirements for Self-Regulatory Organizations; Ownership and Voting Limitations for Members of Self-Regulatory Organizations; Ownership Reporting Requirements for Members of Self-Regulatory Organizations; Listing and Trading of Affiliated Securities by a Self-Regulatory Organization, Securities Exchange Act Release No. 50699 (Nov. 18, 2004).

[59] *See, e.g.*, Comment Letter of Sheila C. Bair, Dean's Professor of Financial Regulatory Policy, University of Massachusetts-Amherst (Sept. 15, 2004) ("By promising a 'culture of compliance' through registration, the SEC may be encouraging investors to take a 'free ride', reducing the amount of due diligence they would otherwise conduct on their own. The first line of defense for sophisticated investors should be their own due diligence, not SEC compliance measures, which are already seriously strained."); Comment Letter of W. Hardy Callcott, Bingham McCutchen LLP (Sept. 15, 2004) ("When *not* promised that the SEC will oversee the adviser, hedge fund investors have been able through private ordering to negotiate adequate protections for themselves – protections apparently at least as effective as those provided by SEC registration and oversight."), Comment Letter of the U.S. Chamber of Commerce ("[C]ounterparty surveillance (*e.g.*, extended pre-investment due diligence by investors and discipline imposed by lenders) is today pervasive among institutions and other sophisticated [private investment fund] investors."); Comment Letter of Price Meadows Inc. (Sept. 15, 2004) (noting that market pressures are enhancing investor protection as reflected in the increasing percentage of hedge funds that are audited or rely on third-party administration).

[60] *See, e.g.,* Adopting Release at text accompanying n. 61 ("But commenters have not persuaded us that requiring hedge fund advisers to register under the Act, requiring them to develop a compliance infrastructure, or subjecting them to our examination authority will impose undue burdens on them or interfere significantly with their operations."). The majority bolstered the cost-benefit analysis and the discussion of alternatives in the final release three weeks after the vote to approve the rulemaking. Such issues should have been thoroughly explored prior to the vote.

[61] *Compare* Adopting Release at n. 64 and accompanying text (relying on the "persuasive testimonials" of two commenters who did not provide empirical data to conclude that registration is not overly burdensome) *with* Adopting Release at text following n. 70 ("The bare assertions of adverse consequences of registration under the Advisers Act offered by many commenters opposed to our proposed rule, and the anecdotal evidence offered by others, simply do not stand up to scrutiny.").

[62] *See, e.g.,* Adopting Release at nn. 344-46 and accompanying text.

[63] In fact, the only cost estimates offered by the majority in its cost-benefit analysis are per-firm costs of $20,000 for professional fees and $25,000 for internal costs that firms would incur in establishing the required compliance infrastructure and aggregate costs of $31 to $57 million. *See* Adopting Release at n. 333 and accompanying text.

[64] *See* Adopting Release at text accompanying n. 320.

[65] *See, e.g.*, Comment Letter of Proskauer Rose LLP (Aug. 31, 2004) ("[F]or certain advisers the benefits of registration exceed the costs and for others the reverse is true, and [] the

gulf can be substantial."). If the majority is correct in its cost estimates, it should be satisfied in simply letting the trend of voluntary registration continue.

[66] Mandating across-the-board registration only serves to eliminate any benefit registered advisers enjoyed in being able to distinguish themselves from unregistered advisers.

[67] *See, e.g.*, Comment Letters of Blanco Partners LP (Sept. 13, 2004) (small advisers will be disproportionately burdened); Venkat Swarna (Sept. 14, 2004) ("We estimate the annual compliance costs of a state or federal registration to be in the range of 20,000 to 25,000. These compliance costs would be prohibitive to a small advisor like ours, as these costs alone constitute a sizeable percentage of the portfolio of the fund we would be managing in our case more than 1[%]"); Joseph L. Vidich (Aug. 7, 2004) ("In a one or two person firm, with 10 million under management, the annual cost of compliance could easily fall between 25,000 and 50,000, which represents twenty five to fifty percent of the firms asset management fee."). *See also Hedge Fund Regulation May Force Consolidation*, PipeLine 3 (June 15, 2003) (reporting study findings that registration would impose significant burdens on small hedge funds in the range of $50,000 to $100,000 annually) (citing Sanford C. Bernstein & Co., *The Hedge Fund Industry—Products, Services, or Capabilities?* (May 19, 2003); Arden Dale, *Small Mutual-Fund Firms Cry Uncle – New Rules Protect Investors, but They Can be a Burden; Cost of a Compliance Cop*, Wall St. J., C15, Sept. 13, 2004 (reporting difficulty of mutual fund advisers that have less than a few billion dollars under management to bear the costs of regulatory requirements, including the Commission's compliance requirement).

[68] *See, e.g.*, Comment Letter of Blanco Partners LP (Sept. 13, 2004) (contending that registration will burden small hedge fund advisers more heavily than the average small adviser); Comment Letters of the International Swaps and Derivatives Association (Sept. 15, 2004) and Guy Judkowski, Hedgehog Capital (explaining that, in contrast to many other small advisers, some small hedge fund advisers deliberately remain small in order to effectively pursue a particular strategy).

[69] Even proponents of registration acknowledge that its costs will be significant enough to deter some advisers from entering the business. *See, e.g.*, Ron Orol, *Regulation? Bring it on*, TheDeal.com, Oct. 11, 2004 (interview of Steven Holzman, the managing partner of Vantis Capital Management LLC, who wrote two comment letters cited repeatedly in support of registration) (Mr. Holzman predicted that registration would help his business by raising barriers to entry and anticipated that "[w]ith registration, we will have half as many new funds starting up next year ... ."). Nonetheless, the majority cites Mr. Holzman for the proposition that barriers to entry are low and concludes that "thus the cost of compliance with these rules should not present significant additional barriers to entry for new hedge fund advisers." Adopting Release at nn. 121-22 and accompanying text.

[70] *See* Comment Letter of the ICAA (Sept. 14, 2004) ("The fact is that investment adviser regulation and compliance have become increasingly complex and costly."). *See also* Comment Letter of Davis, Polk & Wardwell (Sept. 15, 2004) (noting that the costs of registration and compliance are "substantial and increasing" and will be passed on to investors).

[71] *See, e.g.*, Comment Letter of the Managed Funds Association (Sept. 15, 2004) (reporting that one MFA member incurred over $75,000 in staff time in connection with the preparation of Form ADV).

[72] *See, e.g.*, Comment Letter of Guy P. Lander (Sept. 15, 2004) (reporting that client anticipates spending more than $300,000 in the first year to come into compliance with the rulemaking); Comment Letter of the Managed Funds Association (Sept. 15, 2004) (MFA members report incurring more than $300,000 in outside legal and other expenses associated with registration and compliance requirements); Comment Letter of C. Peter Marin, Superior Capital Management LLC (Sept. 8, 2004) (estimating that compliance costs will be 15-20% of revenues of adviser to small hedge fund); Comment Letter of Millrace Asset Group (Sept. 15, 2004) (hedge fund adviser anticipates having to increase staff from four to five to handle compliance under the rulemaking); Comment Letter of Seward & Kissel LLP (Sept. 15, 2004) ("To properly fulfill the breadth of compliance requirements under the Advisers Act, many advisers would be required to hire at least one additional professional at a cost far greater than the estimate provided."). The majority did not attempt to estimate ongoing compliance and examination costs because of the difficulty of doing so, dismisses the estimates it received as "not representative," and instead offers the observation that "one registered hedge fund adviser commented that the firm itself derived benefit from the examination process." Adopting Release at IV.B.3.

[73] The majority explains this failure and its rejection of commenters' estimates by noting that advisers are not required to hire someone to fill the role and the chief compliance officer can have other responsibilities. *See* Adopting Release at text following n. 335. The majority did not attempt to estimate the real, quantifiable cost of the requirement on firms, which must allocate at least a portion of an employee's time to handling the increased compliance functions. *See* Adopting Release at Section IV.B.2.

[74] *See, e.g.*, David R. Sawyier (Sidley, Austin, Brown and Wood) (Sept. 14, 2004) (reporting that two clients, hedge fund advisers, spent between $300,000 and $500,000 preparing for and hosting examiners, without including opportunity costs).

[75] Adopting Release at n. 116. The staff, in its hedge fund report, noted: "We are concerned about our inability to examine hedge fund advisers and evaluate the effect of the strategies used in managing hedge funds on our financial markets." 2003 Staff Hedge Fund Report, *supra* n. 5, at 11. Certainly, then, hedge fund advisers can anticipate that the staff will be looking into, and perhaps regulating, such strategies.

[76] Comment Letter of Guy P. Lander (Sept. 15, 2004). *See also* Comment Letter of the U.S. Chamber of Commerce (Sept. 15, 2004) (advisers might avoid innovative strategies in order to avoid Commission scrutiny).

[77] *See, e.g.*, Alan Greenspan, Chairman, Federal Reserve Board, Testimony before the Senate Banking, Housing and Urban Affairs Committee (July 20, 2004) ("Should the existing proposal fail in achieving its goal, pressure will become irresistible to expand SEC's regulatory reach in an endeavor to accomplish what it set out to do. Hedge fund arbitrageurs are required to move flexibly and expeditiously if they are to succeed. If placed under increasing restrictions, many will leave the industry, to the significant detriment of our economy."). *See also* Comment Letter of the International Swaps and Derivatives

Association (Sept. 15, 2004) (registration will reduce the number of entrants into the hedge fund industry and force others offshore, which will harm the derivatives industry and the market as a whole); Comment Letter of the Financial Services Roundtable (Sept. 15, 2004) (rulemaking might deter "the types of innovative and active trading that serve the marketplace as a whole"); Comment Letter of the Managed Funds Association (Sept. 15, 2004) (the rulemaking "has the potential to create inefficiency and instability in our capital markets by stifling the willingness of hedge funds to act as shock absorbers and provide risk capital in times of market instability"); Comment Letter of Seward & Kissel LLP (Sept. 15, 2004) (rulemaking could raise barriers to entry for new advisers); Comment Letter of Tudor Investment Corp. (Sept. 15, 2004). The majority, in faulting commenters opposing the rule for failing to demonstrate "that hedge funds managed by registered advisers play a diminished role in the financial markets compared to hedge funds managed by unregistered advisers," fails to recognize that the effects of registration might be different for different advisers. Adopting Release at text accompanying n. 71.

[78] The majority's attempt to characterize this as a positive potential effect of the rulemaking is not persuasive. *See* Adopting Release at Section VII (acknowledging that investors might not be able to select the adviser of their choice, but noting that "a hedge fund adviser's decision not to expand its business may make it easier for other advisers to enter the market.").

[79] Adopting Release at text accompanying n. 118. It is difficult to discern how the majority made such a determination without making an estimate of the costs. The majority also argues that, absent registration, hedge fund advisers might not understand how beneficial a strong compliance program is to their business. *See* Adopting Release at text accompanying n. 117. Our intervention is unnecessary to solve this problem; the market will punish advisers who provide less compliance controls than investors want. *See, e.g.*, Comment Letter of Leon M. Metzger (Sept. 15, 2004) ("the Commission may want to consider whether the growing movement toward voluntary registration will accomplish the goals of mandatory registration.").

[80] Adopting Release at text accompanying n. 119.

[81] *See, e.g.*, Comment Letter of Madison Capital Management LLC (Sept. 15, 2004) (predicting that the rulemaking will have the effect of inducing hedge funds to admit retail investors).

[82] 15 U.S.C. 80b-8(a).

[83] *See* amended rule 203(b)(3)-1(d).

[84] *See, e.g.*, Comment Letter of the CFA Institute Center for Financial Market Integrity (Sept. 30, 2004) (noting that the two year redemption criterion "would seem to us to be somewhat arbitrary"); Comment Letter of Madison Capital Management LLC (Sept. 15, 2004) ("the majority's 'private fund' centered regulatory scheme creates an arbitrary distinction among funds"); Comment Letter of the North American Securities Administrators Association ("NASAA feels that the definition of 'Private Fund' is ineffective at distinguishing hedge funds from private equity, venture capital and commodity pools.").

[85] *See, e.g.*, Comment Letter of Gibson, Dunn & Crutcher LLP (Sept. 13, 2004) ("this component is the *only* factor in the Rule itself that can be relied upon to exempt traditional private equity and venture capital funds").

[86] Comment Letter of the Financial Services Roundtable (Sept. 15, 2004) (rule will reach some private equity and real estate fund advisers); Commenter Letter of Gunderson Dettmer Stough Villeneuve Franklin & Hachigian, LLP. (Sept. 15, 2004) (requesting narrower definition of "Private fund" to avoid including other types of investment vehicles).

[87] *See, e.g.*, Comment Letter of Ellington Management Group LLC (Sept. 15, 2004) ("The industry 'buzz' is that, in fact, many hedge fund managers wishing to avoid registration will be trying to institute two-year lockups exactly for this purpose."); Comment Letter of the Greenwich Roundtable (Sept. 15, 2004); Comment Letter of Jeffrey R. Neufeld (Sept. 15, 2004).

[88] The majority inappropriately looks to ease of redeemability as evidence that "hedge fund advisers are effectively providing advisory services to the fund's investors." *See* Adopting Release at n. 237.

[89] *See, e.g.*, Comment Letter of the Greenwich Roundtable (Sept. 15, 2004) ("If the intention of the Rule is to specifically exclude venture capital and private equity funds, then those funds can more easily be excluded without harming genuine hedge fund investors. We would suggest instead that the Rule apply a test that focuses on the marketability of a fund's holdings, rather than on an investor's willingness to lock-up an investment."); Comment Letter of Kynikos Associates (Sept. 15, 2004) (recommending distinguishing funds on the basis of "investment characteristics"); Comment Letter of the North American Securities Administrators Association (recommending a test based on frequency with which securities in fund are traded). *See also* Comment Letter of Ellington Management Group LLC (Sept. 15, 2004) (recommending distinguishing hedge funds from other types of private investment funds by looking at how the fund employs net asset value in determining management fees and setting purchase price and redemption fees). The majority explains that it rejected this approach in order to prevent advisers from altering their investment strategies to avoid registration. *See* Adopting Release at n. 225. It is much easier for advisers to alter their redemption period in order to avoid registration.

[90] *See, e.g.*, Comment Letter of Kynikos Associates (Sept. 15, 2004) (noting that while venture capital and private equity funds are "somewhat different" from hedge funds, the Commission's concerns, including particularly valuation, are nevertheless applicable); Comment Letter of Leon M. Metzger (Sept. 15, 2004) (interim valuations matter for other types of private funds, *e.g.*, for purposes of the valuation of a deceased investor's estate); Comment Letter of the Committee on Private Investment Funds, The Association of the Bar of The City of New York (Sept. 15, 2004) (although of "more limited relevance," in the venture capital and private equity context, valuation is important for purposes such as investor reporting, and marketing follow-on funds).

[91] Comment Letter of the National Venture Capital Association (Sept. 15, 2004) ("NVCA believes that the [proposing] Release and the proposed rule create a risk of future burdensome regulation on venture capital that outweighs any investor protection benefit that would come from the proposed rule.").

[92] The majority also argues that the third prong of the definition, which limits "private funds" to those that are marketed based on the skills, ability, and expertise of the adviser, "confirm[] the direct link between the adviser's management services and the investors." Adopting Release at text preceding n. 168. If this reasoning is sound with respect to hedge funds, the same link exists between investors in venture capital and private equity funds and the advisers of those funds.

[93] 15 U.S.C. 80b-3(b)(3). When Congress amended section 203(b)(3) in 1980 to preclude looking through business development companies in counting clients for purposes of that section, Congress did not "intend to affect adversely the status of investment advisers which are not registered under the Act." H.R. Rep. No. 96-1341, at 62 (1980).

[94] The Commission explained that this safe harbor was "not intended to specify the exclusive method for a limited partnership, rather than each limited partner, to be counted as a 'client' for purposes of section 203(b)(3) of the Act." Definition of "Client" of an Investment Adviser for Certain Purposes Relating to Limited Partnerships, Investment Advisers Act Release No. 983 (July 12, 1985) [50 FR 29206 (July 18, 1985)].

[95] *See, e.g.,* Definition of "Client" for Certain Purposes Relating to Limited Partnerships, Investment Advisers Act Release No. 956 (Feb. 25, 1985) [50 FR 8740 (Mar. 5, 1985)] ("Where an adviser to an investment pool manages the assets of the pool on the basis of the investment objectives of participants as a group, it appears appropriate to view the pool — rather than each participant — as a client of the adviser.").

[96] *See* Status of Investment Advisory Programs under the Investment Company Act of 1940, Investment Company Act Release No. 22579 (Mar. 24, 1997) [62 FR 15098 (Mar. 31, 1997)] (adopting rule 3a-4 under the Investment Company Act [17 CFR 270.3a-4(a)] to provide a nonexclusive safe harbor from the definition of investment company for certain programs under which investment advisory services are provided on a discretionary basis to a large number of advisory clients having relatively small amounts to invest). Among the safeguards in the rule is a requirement that the sponsor of the program must obtain sufficient information from each client to be able to provide individualized investment advice to the client and periodically update the information. *See* rule 3a-4(a)(2). The majority, in support of its approach, posits a situation in which a group of individual clients of an adviser is combined into a hedge fund in order to avoid application of the Advisers Act. The majority's hypothetical example does not tell us whether the investors continue to receive personalized advice. *See* Adopting Release at text accompanying nn. 177-78. If they do not, there is nothing inappropriate about the adviser's characterizing the group as an unregistered investment company; they *should* be characterized as such, so long as they meet the applicable criteria to be classified as a private investment company.

[97] Status of Investment Advisory Programs under the Investment Company Act of 1940, Investment Company Act Release No. 22579 (Mar. 24, 1997) [62 FR 15098 (Mar. 31, 1997)].

[98] In instances in which an entity is merely a legal artifice, advisers, of course, are prohibited from counting it, rather than its investors, as clients in order to avoid registration. *See* section 208(d) of the Advisers Act [15 U.S.C. 80b-8d] (making it "unlawful for any person indirectly ... to do any act or thing which it would be unlawful for such person

to do directly."). This does not describe the hedge funds the advisers of which are the intended targets of the new rulemaking.

[99] *See, e.g.,* Comment Letters of Schulte Roth & Zabel LLP (Sept. 15, 2004); U.S. Chamber of Commerce (Sept. 15, 2004); Willkie, Farr & Gallagher (Sept. 13, 2004), Wilmer Cutler Pickering Hale and Dorr, LLP (Sept. 8, 2004).

[100] The majority speculates that Congress might not have intended for the legal entity to be treated as the client in the hedge fund context as it is in the investment company context. *See* Adopting Release at n. 171. But for their ability to rely on statutory exemptions from the definition of "investment company" under the Investment Company Act, hedge funds generally would fit within the definition. The approach of treating the entity, not the investors, as the client is equally appropriate in both cases.

[101] Investment Advisers Act, Section 203(b), P. L. No. 76-768, 54 Stat. 847, 850 (1940).

[102] *See* Investment Company Act Amendments of 1970, H.R. Rep. No. 91-1382, at 39 (1970).

[103] *See* Adopting Release at n. 139.

[104] Investment Trusts and Investment Companies: Hearings on S.3580 before a Subcommitteee of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess. 179 (1940) (David Schenker, Chief Counsel of the Investment Trust Study, explained: "The total assets play no part in the determination as to whether a company is a public investment company or a private investment company ... .").

[105] S. Rep. 104-293, at 10 (1996).

[106] 15 U.S.C. 80a-3(c)(7).

[107] S. Rep. 104-293, at 10 (1996).

http://www.sec.gov/rules/final/ia-2333.htm